GCA DIGEST

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RECENT CASES AFFECTING KEY CONTRACTING ISSUES

(Editor's Note. Since the practical meaning of most regulations are what the appeals boards and courts say they are, the following summarizes important decisions in the last year. This is the second of two articles where last issue we focused on cost and pricing issues and here we will address evaluations of proposals, successful and unsuccessful protests and justifications of price adjustments on contracts due to changes and mistakes. This article is based on the January 2000 issue of Briefing Papers written by Marshall Doke, William Whitehall and Neil Cannon of the law firm of Gardere & Wynne, L.L.P.)

♦ Evaluations of Sealed Bid Proposals

To be considered for award a bidder must be responsive and numerous cases have clarified the elements of responsiveness. The bid must contain an unequivocal offer to perform without exception the exact thing called for in the Invitation for Bid (IFB) (*Interstate Construction*). Responsiveness must be ascertained from bid documents themselves not from clarifications provided by the bidder after opening because such later clarifications would be tantamount to granting an opportunity for a new bid (*Ellicott Engineering, Inc.*). Examples of non-responsive bids are where a bidder attempts to impose conditions that would modify material requirements of the IFB or limits the government's liability or rights under any contract clause such as qualifying terms and conditions (*Walashek Indus. & Marine)* or taking exceptions to delivery terms (*Valley Forge Flag Co.*). In addition a bidder may not be given the opportunity to correct a bid to remove a material qualification (*Interstate Const.*).

♦ Evaluation of Negotiated Contracts

All contracts other than sealed bids are considered "negotiated" contracts and their purpose is to permit agencies to use flexible procedures and to have discussions that may result in modifications of proposals to correct deficiencies or improve their offers. There have been numerous cases addressing some of these "flexible" procedures such as proper evaluation factors, past performance, proper discussions, exclusions from the competitive range and proper scoring of proposals.

Evaluation factors. The request for proposals must describe the factors and significant subfactors that will be used to evaluate proposals, their relative importance and that proposals will be evaluated "solely" on the factors and subfactors. Though it is improper for an agency to evaluate factors or subfactors not included in the RFP, agencies are not required to identify *all areas* of each factor that may be taken into account as long as they are reasonably related to the stated criteria (*D.F. Zee's Fire Fighter Catering*). For example, it was ruled proper for an agency to consider the size and similarity of past contracts in a past performance evaluation (*J.A. Jones Grupo de Servicios*), experience in three specific programs when evaluating the technical/management section (*Advanced Data Concepts, Inc.*) and considering factors on an evaluation checklist because they were "directly related" to an evaluation factor in the solicitation (*Phantom Prods. Inc.*). When the subfactors are not disclosed, they are understood to be of equal importance to each other (*Contract Sec. Servs. Corp.*).

Past performance. Past performance has become a critical award factor and many decisions have ruled an agency has discretion to determine the scope of the offeror's performance history. Though the government generally has no obligation to contact all references (*OMV Med. Inc.*) examples of exceptions include when the information is simply too close at hand and too relevant for the agency to ignore (*TRW, Inc.*) and when the government is aware of prior performance information (*Consolidated Engineers, Inc.*).

It is improper for an agency to downgrade a competitor's past performance evaluation merely because of a history of filing claims (*Nova Group, Inc.*). However, one decision allowed a downgrade because a company president, who disagreed with inspectors, was "difficult to work with" (*Crescent Helicopters*). Also, a downgrade was allowed when a contract was terminated for default even though the contractor appealed the termination and the parties entered into a settlement agreement (*Wilderness Mountain Co.*).

Discussions. FAR 15-306 requires that COs *discuss* with each offeror being considered for award significant

weaknesses, deficiencies and other aspects of the proposal that could, in the CO's opinion be altered or explained to materially enhance the proposal's chances of award (*ASC Government Solutions Group, Inc.*) There is no requirement for discussions where the solicitation advises bidders of the possibility of award without discussions (*Century Elevator Inc.*). The nature of the discussions with offerors who are in the competitive range must be meaningful, equitable and not misleading (*Communities Group*) and are considered adequate if they are advised of weaknesses, excesses and deficiencies in their proposals (*Professional Performance Dev. Group, Inc.*).

Recent rulings on discussions have provided COs broad discretion. Discussions must be "meaningful", meaning they must lead bidders into areas of their proposal requiring amplification or revision (*LB&B Assocs. Inc.*). But agencies are not required to "spoon feed" them (*Labat-Anderson, Inc.*). Agencies may not conduct discussions in a manner that favors one offeror over another where, for example, an agency explained deficiencies of a proposal to one where two others with similar deficiencies were not provided similar treatment (*Chemonics Intl., Inc.*). Though offerors must be treated fairly and given an equal opportunity in discussions to revise proposals, discussions need not be identical (*KBM Group*).

Competitive Range. Based upon the ratings of each proposal against all evaluation criteria, the CO must establish a "competitive range" of the most highly rated proposals unless the range is further reduced for purposes of efficiency (*United Housing Servs. Inc.*). An agency is not required to retain a proposal in the competitive range simply to avoid a range of one (*Clean Srv. Co.*).

Recent Changes to FAR Part 15. Whereas before the rewrite there was clearly prohibitions against reopening discussions after receipt of BAFOs, there was no such prohibitions after the rewrite (*Spectrum Sciences & Software Inc.*). Also, while auctions are prohibited, the use of auction techniques are allowed (*DGS Contract Serv. Inc.*).

Scoring Proposals in the Competitive Range. There have been numerous cases providing that the CO has wide discretion in how it will score proposals in the competitive range. Scoring will be reversed only where it lacks a reasonable basis or conflicts with stated evaluation criteria for award. An agency's evaluation of proposals must be documented in sufficient detail to allow for review in the event of a protest (*Acepex Mgmt. Corp.*). Point scores must be supported by documentation of the relative differences between proposals, their weaknesses and risks and the basis and reasons for the selection decision. Where a price/technical tradeoff is made, the documentation must include the rationale for any tradeoffs made including the benefits associated with additional costs (*Opti-Lite Optical*).

♦ Changes Justifying Price Adjustments

Constructive Changes. There were numerous decisions that clarify when a constructive change does and does not occur that would allow for a contract price adjustment. A constructive change occurs when a contractor is required to perform work beyond contract requirements without a formal "change" order *(see GCA DIGEST Vol. 1 No. 1 for a discussion of constructive changes).* Constructive changes were held to occur when (1) the type of wire mesh specified in the contract was commercially unavailable and the government insisted on using another type of mesh (*Technocratica*) and (2) the government required completion of the original contract date even though the contract had been delayed pending resolution of a differing site condition (*Earth Tech Indus.*).

For constructive *acceleration* of a contract the contractor must establish five elements: (1) there was an excusable delay (2) the government had knowledge of the delay (3) the government acted in a manner that reasonably could be construed as an order to accelerate (4) the contractor gave notice to the government that an "order" amounted to a constructive change and (5) the contractor actually accelerated and thereby incurred added costs. The order to accelerate need not be couched in terms of a specific command but a request to accelerate or even an expression of concern about lagging progress may have the effect of an order (*Fru-Con Const. Corp.*).

For claims related to government *interference and delay*, the contractor needs to show (1) the specific delays were attributable to government responsible causes (2) they resulted in delay of the overall project and (3) the government-caused delays were not concurrent with delays within the contractor's control (*Technocratica*). Another case showed that the contractor must prove the government was the "sole proximate cause" of the delay when in spite of the government allowing a delay, the government was able to avoid a price adjustment when it showed the delay (1) was intended to reestablish a new delivery date following performance delinquencies (2) there was no indication the government admitted to accepting any responsibility for the delay and (3) the government

presented proof the contractor was responsible for part of the delay (*Essex Electro Engrs., Inc*).

Assertions of changes caused by *defective design specifications* have been ruled on. When drawings are deemed to be design specifications, the agency is liable for any defect in the design (*Apollo Sheet Metal*). Even if a contract provided language requiring a contractor to identify errors, the contractor was entitled to an equitable price adjustment for efforts related to preparing engineering change proposals (*Essex Electro Engrs., Inc.*). Though the contractor bears the risk for obvious omissions and apparent inconsistencies or discrepancies, it does not bear such risk of deficiencies if it cannot be gleaned from a knowledgeable reading of the contract and therefore it first becomes detectable only through discriminating study or later during actual performance (*M.A. Mortenson Co.*).

Merging of companies. When two companies *merge* numerous decisions have held the surviving company can pursue all claims of the contract but the following indicates problems when there is a *sale of assets*. Following a sale, the Board ruled it could not settle a claim because there was no "contract" since no novation agreement took place. The writers not only remind companies of the need to execute such novation agreements, but due to the often long process of approving such agreements, the contractor should authorize the successor to pursue claims in the name of the contractor.

♦ Protests

Interested Party. To successfully protest, 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 receive the award (*CW Govt. Travel, Inc.*). A protester is not an interested party if it would not be in line for award if the protest is sustained. Hence, exclusion from the competitive range (*OMV Med Inc.*) or failure to submit a proposal (*Interproperty Invs. Inc.*) is grounds for exclusion. A third ranked bidder was considered an "interested party" though a second ranked one was next in line since the protestor claimed its proposal was improperly evaluated and it should have received a higher rating (*Systems Integration & Research, Inc.*).

Bases for a Protest. A protester need not prove it would have won the award (*Acepex Mgmt. Corp*) but only that it had a "reasonable possibility" of winning but for the agency's actions (*Metro Mach. Corp.*) A protest asserting failure to hold discussions was not sustained because even though such procedural steps were not appropriate, it was apparent the protester could not have improved its proposal enough to be in contention for award (*Charleston Marine*).

Even though an agency has broad discretion the courts have set forth the conditions for overturning an award. Decisions may be reviewed for reasonableness, whether the agency's decision is consistent with the terms of the solicitation and applicable statutes and regulations or whether the agency acted fraudulently or in bad faith (*Intellectual Properties Inc.*) A protest must contain an allegation of improper conduct by the agency. The protest should include a detailed statement of the legal and factual grounds for the protest where it is shown the agency took particular actions and those actions were contrary to law or regulations (*Charleston Marine Containers*).

Inadequate Solicitations. Many of the recent successful protests revolved around inadequate solicitations. Adequacy of a solicitation requires, as a general rule, sufficient detail to enable bidders to compete intelligently and on a reasonably equal footing. Examples of decisions include:

1. FAR Part 10 requires agencies to conduct market research to determine if commercial items are available and ascertain related commercial practices. An agency's failure to conduct market research to confirm customary industry practices when specifying requirements may result in a successful protest (*Smelkinson Sysco Food Servs.)*

2. Though an agency has broad discretion to select an evaluation scheme in a solicitation, cost or price to the government must be included as an evaluation factor in every government solicitation (*S.J. Thomas Co.*).

3. An agency's "intent" expressed in a legal solicitation is not a legal requirement so the award of a single contract even though the solicitation stated the agency intended to award two was not sufficient to win the protest (*Canadian Commercial Corp.*).

4. FAR 15.306 allows the CO to limit the number of proposals in the competitive range to the greatest number that will permit an efficient competition but the solicitation must advise offerors of this intent (*Matrix Gen. Inc*).

5. Under negotiated procurements, the CO has broad discretion in deciding whether to cancel a solicitation as long as there is a "reasonable" basis

such as the government no longer has a need for the items solicited (*Safety Storage Inc.*). Under sealed bidding, the discretion is much more limited, only when there is a "compelling reason." Such compelling reasons have been held to be when only one bid is received or when more than one bid is received but all prices are held by the agency to be unreasonable (*Quality Inn & Suite Conference Center*).

♦ Mistakes

There were several decisions clarifying what is and is not an acceptable mistake. FAR 14-407 provides that a bidder's request for an upward correction of a bid before award may be granted only where the request is supported by clear and convincing evidence and both a mistake exists and the intended bid and correction would not result in displacing one or more lower bids. Computer generated workpapers that are in good order and clearly indicate the intended price are considered as clear and convincing evidence (*Holmes Mechanical Inc*) but workpapers not in good order (e.g. not updated) may result in denial of relief (*Stanley Contracting Inc.*).

When a *unilateral* mistake is made only by the contractor five essential elements must be proved: (1) a mistake in fact occurred before contract award (2) the mistake was a clear-cut clerical or mathematical error or a misreading of the specification and not a judgmental error (3) before award the CO knew or should have known the mistake had been made and should have therefore requested bid verification (4) the CO did not request bid verification or the verification was inadequate and (5) the evidence placed in the record clearly establishes the amount of the intended bid (*Comspace Corp.*). For a *mutual* mistake the erroneous belief held by the parties must relate to an existing fact not a prediction or judgement regarding a future event. Relief will be denied if it cannot be shown the party whom reformation is sought would have agreed to the relief had it known of the correct facts from the onset (*ENCORP Intl., Inc*).

DISPUTE ON DIRECT VERSUS INDIRECT CHARGING: A CASE STUDY

(Editor's Note. We received an interesting question from one of our readers who was asking for some regulatory guidance on how to challenge DCAA's assertion that certain legal costs charged directly to a government contract should have been charged indirectly and hence allocated to all contracts on a prorata basis. It was particularly interesting because we had just finished challenging the opposite - an audit opinion that the same type of legal costs should have been charged directly to commercial contracts and not included in indirect cost pools where the costs would be allocated to all contracts including government cost type work. Both positions were put forth by the Defense Contract Audit Agency during their incurred cost audits and, not surprisingly, they took opposite positions on the same type of costs that resulted in less costs being allocated to federal reimbursable contracts. During our client's challenge of DCAA's position that the questioned costs should be allocated directly to commercial contracts rather than indirectly, the client sought a written opinion from both our firm and a well known law firm. We thought we would summarize the arguments presented in the opinions because (1) disputes on direct versus indirect charging is common (2) the issues presented are not limited to legal costs but affect numerous other types of costs and (3) our readers would be interested in seeing "real life" legal and consulting positions in defense of a client. We assure our readers the legal opinion is real but we decided not to identify the law firm in case we missed a nuance of their argument that they might take exception to.)

♦ Background

The contractor is a rather large engineering firm working on a variety of contracts with commercial, local/state agencies and the federal government. Because of the high cost of insurance the contractor did not insure itself against third party law suits alleging errors and omissions (E&O) and/or professional negligence. These law suits are common in the industry and typically occur years after an engineering study is complete and the structure is built or fixed where some third party might be injured and their lawyers sue everyone involved in the project. The legal costs in question were the in-house and outside legal expenses involved in defending against these third party lawsuits as well as the costs of settling them before they went to court. The lawsuits in question happened to be related to commercial contracts that were completed several years before the legal costs were incurred. Like most of its other legal costs, the contractor charges these costs indirectly in the period they are either incurred or the liability is known with reasonable certainty. The contractor has a disclosure statement and written government accounting policies and procedures where criteria for charging direct and indirect charges are addressed and the manner of charging many (but not all) expenses are discussed.

♦ DCAA Position

In its draft audit report and subsequent discussions DCAA did not assert the legal costs are *unallowable* because they obviously do not meet any of the prohibitions of FAR 31.205-47, Legal and other proceeding. Rather their position is these legal costs are not *allocable* to government contracts because (1) the expenses are related to specific contracts and hence they should be charged directly to those contracts that caused the lawsuit or (2) in any case, they should not be charged to the government. In defending their position, DCAA cited the following laws, regulations and court case:

1. FAR 31.203(a). Indirect costs. This section defines an indirect cost as a cost not directly identified with a single final cost objective (e.g. contract) but rather with two or more cost objectives. Since the costs in question should be charged to the commercial contracts related to the lawsuits, they cannot be charged indirect.

2. FAR 31.201-4, Determining allocability. This section identifies three conditions for a cost to be allocable to a government contract: (a) incurred specifically for the contract (b) benefits both the contract and other work and can be allocated on a reasonable proportion basis and (c) necessary for the overall operation of the business. DCAA asserts neither the second or third condition applies, and hence the cost should be a direct cost of the commercial contract that gave rise to the lawsuit.

3. CAS 418.30. These are definitions of direct and indirect costs. Since the contractor is covered by CAS the auditor chose to cite definitions of direct versus indirect and state the legal expenses were direct costs.

4. *FMC Corp Northern Ordnance Division (FMC Corp), ASBCA No. 30130*. This FMC case is put forth as support for DCAA's position since it rules that costs of litigation in a specific contract were attributable solely to that contract and not to the contractor's G&A pool.

♦ Response

Our consulting firm and the law firm met several times with DCAA and responded in writing that the disputed legal costs were properly charged to the indirect cost pool and hence should be allocated to all contracts including federal cost type contracts and subcontracts. The reasons put forth were as follows:

1. *Consistent with established practices and written policies and practices*. Since the contractor has always charged its E&O costs as indirect, it has an established practice. In addition, the contractor's disclosure statement identifies specific costs that are considered direct (e.g. labor, materials, rental equipment) and legal costs are not included in this category. Though legal costs are not identified as indirect costs, "professional services" are one of the categories identified as indirect and legal costs certainly qualify.

2. *Consistent with the contractor's own definitions of direct versus indirect cost*. Though it is possible, with enough time and effort to identify any cost with a final cost objective, the contractor, like most others, recognizes such precision is not worth the effort. Instead, it limits direct charges to those costs that "add value" while charging remaining costs indirect. Hence, legal costs are direct costs only when the costs are in direct support of contract performance or contract administration (e.g. negotiations of individual task orders; otherwise they are indirect).

3. *CAS takes precedence over FAR for allocation of costs*. When it comes to how costs should be allocated as opposed to questions about allowability, the CAS Board has established it has "the exclusive statutory authority" to assess "cost accounting practices governing measurement, assignment and allocation of costs to contracts and subcontracts" (Pramble to Recodification" of the CAS principles in 1992). In addition, Aydin Corp. v. Widnall, 61 F.3d 1571 ruled that CAS takes precedence when it is applicable.

The fact CAS takes precedence over FAR is important because CAS 418, Allocation of direct and indirect costs, puts the responsibility of defining how a cost is to be treated squarely on the contractor not the government. To ensure the contractor's decisions are reasonable CAS 418 establishes only two criteria: (1) the classification of whether a cost is direct or indirect must be made "pursuant to a written statement of accounting policies and practices for classifying costs as direct or indirect which shall be consistently applied" and (2) a cost is either direct, which is defined as any cost identified to a particular final cost objective, or it is indirect. The contractor is provided extensive flexibility in determining how to treat a cost and is instructed to make their decision applying the above definition reasonably and in a written statement of policies and procedures.

4. *Case law provides it is reasonable to charge legal costs indirect when incurred after physical performance.*. Our client does not argue the legal costs *must* be charged indirect

but only that it is *reasonable* to do so, meeting the criteria of CAS 418. They cite several cases holding that legal costs incurred after physical performance have no direct bearing on either performance or administration of the contract and thereby are indirect costs. In *Singer Corp.*, the court ruled the legal costs incurred for the submission of a request for equitable adjustment (REA) after performance of a contract did not have a "sufficient nexus to the successful completion of the contract" to be allowed as a direct contract cost. In *Gulf Contracting*, professional fees expended for preparing an REA that were directly charged to the contract were ruled unallowable costs to the contract because only costs "related to performance or administration of an ongoing contract" can be considered direct and that expenses incurred after completion "bear no relation to production or administration".

5. *The FMC case is not relevant.* In the case DCAA cited for its position, the court ruled FMC should charge costs direct to a subcontract when that subcontract was still open and FMC's disclosure statement stated professional services "are charged direct when specifically related to a contract task." In the FMC case, though the subcontract was physically complete it was still administratively open and the disclosed practices clearly stated the costs should be direct. In addition, the lawsuit itself was between the actual contracting parties intended to untangle their respective contract rights and not part of a third party lawsuit where the party had nothing to do with the original contract.

6. *The legal costs are really an indirect, period cost in the year it is incurred.* Assignment of the cost is the means used to associate a cost to a specific fiscal year where they are assigned either to the year of incurrence or future years. *In Stanwick Corp., ASBCA No 18083*, the board ruled costs may never be assigned to years prior to when the cost was incurred. This is logical since even though occurrence of a prior event may give rise to the need for legal services, there is no means at the time to estimate and hence accrue the costs prior to when they were incurred. According to FASB No. 5 a cost exists either when there is a binding liability or the expenditure of cash, whichever occurs earlier. The costs in question cannot be assigned to an earlier period since it is impossible to know what the legal liability is or even if there will be one. Such "costs" in an earlier period would be unrecognizable contingencies and not costs. A cost assigned to a fiscal year may be a direct cost only if it is identifiable specifically with a final cost objective in existence during that year; in any other circumstance, it is an indirect cost.

7. *The legal costs in question are similar to environmental remediation costs.* Like the legal costs questioned here, environmental remediation costs are usually incurred long after the full performance of the contract that caused the contamination. Under DCAA's own guidance (DCAA Policy Memorandum, October 12, 1992) environmental remediation costs caused in prior years will "generally be period costs" and should be allocated to "residual G&A costs." DCAA clearly recognizes these costs to be "period" costs to be expensed in the current fiscal year and that they should be allocated indirectly because there is no specific cost objective in that year that benefits from or caused exclusively the costs.

8. *DCAA's Position Violates CAS 402 and CAS 401.* CAS 402, requiring consistency in treating similar costs under similar circumstances, would be violated because DCAA attempts to have the contractor select a single type of cost from its indirect cost pool and reassign it in a manner inconsistent with its disclosed written policies and historical accounting practices. CAS 401, requiring consistency in estimating and costing, would also be violated because for proposal purposes the costs can only be treated indirectly because there is no way to accurately estimate future third party legal costs for a given contract.

9. *CAS 418 allows immaterial direct costs to be charged indirectly.* In the Preamble to CAS 418, a contractor should be required to make an accounting change only if the result has a "materially different cost impact on a government contract." Except for one year, the costs in question represent an immaterial amount of the total indirect costs (less than 2 percent) and hence there would be an immaterial impact on the government contracts.

10. *CAS 410 requires allocation to all contracts.* DCAA challenged the allocation of the questioned legal costs to government contracts even if it was appropriate to charge them indirectly. The legal costs were incurred to defend the contractor from a corporate liability. Whether it is from a commercial, local or federal government contract, defense of E&O cases benefit the company as a whole by protecting the company against potentially catastrophic damages and it is appropriate that government contracts share the burden. CAS 410-30(a)(6), Allocation of G&A costs, requires that an allowable expense that benefits the entire business should be allocated equitably to all of the business customers.

After the above responses were communicated to the contracting officer and reviewed by its legal staff and price analysts, the CO decided it would not support DCAA's position the legal costs should be rejected. Rather, a "compromise" was agreed to where the legal costs would be treated as self-insurance costs and a calculation based on CAS 416, Insurance costs would be made and included as an indirect cost for both estimating and costing purposes. Any excess would be questioned.

RESEARCH AND DEVELOPMENT COSTS

(Editor's Note. We have received numerous inquiries on what qualifies as research and development costs and what is the proper way to account for such costs. The diversity of costs related to research and product/service development, whether incurred in-house, expended by an affiliate or purchased outside, has led to a blurring of what is and is not R&D. Following cessation of limits on R&D costs audit scrutiny subsided but the government's increased budgets for R&D, expansion of numerous federal programs affecting R&D expenditures (e.g. other transactions, SBIR's, etc.) and the fact it is often a significant G&A cost has caused audit attention to recently increase. We thought it would be a good idea to review the basics of the cost principles, discuss allocation and review audit guidance. Whereas R&D and bid and proposal costs are usually lumped together in regulations (e.g. FAR, CAS 418) they are significantly different to warrant a separate treatment so we will discuss B&P costs in a separate article. Though we do not use any particular reference authority, we have relied on some of our favorite texts, Mathew Bender's "Accounting for Government Contracts" for both Federal Acquisition Regulations and Cost Accounting Standards as well as the referenced DCAA Contract Audit Manual.)

♦ Definitions

Research and development includes basic and applied research, development and systems and other concept formulation studies. At the least practical level is basic research whose purpose is to increase scientific knowledge where emphasis is on obtaining a fuller understanding of a field rather than discovering practical applications. At the next level is applied research that seeks to exploit scientific gains or advance the state of the art but does not include efforts to design or develop actual products or services. Development refers to the use of scientific or technical knowledge to design and develop new products or services. Finally the systems and other concept formulation studies are analyses and study efforts either related to specific R&D projects or directed toward identifying desirable new or improved systems, equipment or components. R&D costs are sometimes confused with other categories of costs such as precontract costs (FAR 31.205-32), selling costs (FAR 31.205-38) and manufacturing and production engineering costs (FAR 31.205-25) and judgement and clear definitions within the company should be established if confusion is anticipated.

The regulations address distinct types of effort: (1) sponsored research and development (simply R&D) that is required in performing a contract or grant and (2) Independent research and development (IR&D) that includes the four types of effort described above. Each type has significantly different cost recovery rules. In addition there are technical efforts expended to support a bid or proposal and these are not considered IR&D.

♦ Allocability of Research and Development Costs

Both R&D and IR&D costs are treated as a separate cost objective (often with its own job number) for purposes of accumulating costs. Only the sponsored R&D costs are treated as *final* cost objectives where general and administrative costs can be allocated and revenues recognized. If R&D costs exceed a contract or grant value, the excess is usually unallowable and cannot be considered a valid cost of the contract unless, as *Unisys Corp* showed, certain costs were legitimately charged to IR&D on the grounds the efforts were not required by the contract terms. IR&D costs, on the other hand, are commonly considered period costs and their allocability as indirect cost to government contracts are governed by cost accounting standards.

What constitutes IR&D and B&P costs and their allocation are established by CAS 420, "Accounting for Independent Research and Development and Bid and Proposal Costs". The basic unit of accumulation is an individual IR&D project. Projects that are immaterial in amount can be accumulated together in a single account or job number. So, for example, a contractor can set a threshold, say $5,000, where only if a project is expected to exceed this amount will a separate project number be assigned. Costs are assigned to IR&D projects as if they were final cost objectives (e.g. contracts, task orders, etc.) except CAS 420 states G&A costs may not be applied to the IR&D projects.

Depending on the nature of the projects, IR&D costs can be accumulated at the corporate, group or business segment level. The proper accumulation point is whether the costs benefit one segment, multiple segments within a group or all segments.

♦ FAR Provisions

The basic provisions of CAS 420 have been incorporated into the Federal Acquisition Regulation. Hence non-CAS covered contracts and contracts subject only to modified coverage must still meet all provisions of CAS 420 except for CAS 420.50(e)(2) and 420.50(f)(2) which have to do with specific rules on allocation of costs from a home office to a business unit or within a business unit to cost objectives (*a bit to detailed to get into here*).

The FAR requires that IR&D costs be allocated like G&A. The base used to allocate G&A costs is commonly accepted as the base for allocating IR&D costs based on the rationale that like G&A expenses, IR&D relate to the overall operation of a business. Likewise, IR&D costs are routinely included in G&A pools, either in the corporate G&A pool or if other business units have their own G&A pools, then through the separate G&A pools at those business units.

The FAR permits use of an allocation base other than the G&A base if (1) the results of using the G&A allocation base are inequitable and (2) the contracting officer approves use of an alternative base. The existence of two product lines within a business unit with varying requirements for IR&D costs could be an example of a set of circumstances justifying use of a base other than the one used for allocating G&A. In practice COs rarely grant approval when initiated by a contractor but we have seen several attempts by auditors to create a separate allocation base when they believe a commercial product line benefits more than products sold to the government.

Beginning in 1997, all IR&D costs are allowable if they are reasonable in amount and are allocable to a contract. This is a significant change over earlier rules that limited reimbursement. Those earlier rules limited reimbursement of IR&D and bid and proposal costs to specific formula calculations that were phased out in the 1990's and eliminated by 1997.

♦ DOD Conditions of Allowability

In its Department of Defense FAR Supplement (DFARS) Part 231.205-18, DOD provides an additional condition for allowability of IR&D costs to DOD contracts – they must have "potential interest" to DOD. These activities should accomplish at least one of the following:

1. Enable superior performance of future U.S. weapon systems and components;
2. Reduce acquisition costs and life-cycle costs of military systems
3. Strengthen the defense and technology base of the U.S.
4. Enhance the industrial competitiveness of the US
5. Promote the development of technology identified as critical in the DOD plan
6. Increase the development of technology useful for both the private commercial sector and the public sector
7. Develop efficient and effective technologies for achieving environment benefit.

In practice, these seven conditions are so broad that virtually any IR&D efforts could qualify and as such we have not seen any successful challenges to IR&D expenses on the grounds they were not of "potential interest" to DOD.

♦ Deferred Independent Research and Development Costs

We should say a word about a unique opportunity to recover certain IR&D costs in a period later than when they were incurred. This is an opportunity that not even generally accepted accounting practices (GAAP) allow. Generally, GAAP as well as government accounting rules require that IR&D costs be expensed as incurred. In certain limited circumstances, these costs can be deferred for government cost and pricing purposes. Such deferral can be quite beneficial when, for example, a contractor wants to lower proposed costs in earlier years or more properly match expenses with products or services developed and sold.

IR&D costs incurred in prior periods are allowable if a contractor has developed a specific product at its own risk in anticipation of recovering those costs in the sales price of the item. To do so, four other conditions must exist:

1. the total IR&D costs applicable to the product must be identifiable
2. the proration of the IR&D costs to product sales must be "reasonable" – from the government's perspective, the allocation must be equitable
3. either the contractor must not have had government business when the IR&D costs were

incurred or else IR&D costs must never had been allocated to government contracts and
4. no incurred IR&D costs for any project can be allocated to government contracts except for the deferred costs related to the specific product.

Court and appeals cases (e.g. *Sperry Rand Corporation, Ford Instrument Company Division*) have held that for deferred IR&D costs to be considered allowable the costs must first be capitalized and then amortized. For other than fixed price contracts, the deferred costs to be recognized should have a specific provision in the contract setting forth the costs than can be allocated or otherwise they will likely be considered unallowable.

♦ Government Challenges

We are seeing increased scrutiny over reviews of IR&D costs, particularly if they are justified as research and development or should be considered production costs. Certain precontract costs, losses on grants and contracts, overruns on other projects, postcontract costs, contractors' portions of cost sharing contracts and costs chargeable to funded research and development costs are not supposed to be included as IR&D costs and auditors can be expected to determine if these conditions exist. When these assertions are made the effect is usually to eliminate the cost from the G&A pool and allocate it directly to the contract that is overrun and hence make the cost unallowable. We have even seen circumstances when auditors inappropriately recommended penalties on these "unallowable" costs.

♦ Audit Guidance

Section 7-1500 of the Defense Contract Audit Agency Contract Audit Manual (DCAM) specifically addresses IR&D costs. It defines it as technical effort not sponsored by or required for a contract or grant consisting of projects falling into the four areas identified above: (1) basic research (2) applied research (3) development and (4) systems and other concept formulation studies. It also states that all contractors, whether they are CAS covered or not, are subject to most provisions of CAS 420 that are incorporated into FAR 31.205-18(b).

General Considerations

The audit guidance identifies specific areas for reviewing proposed IR&D costs:

1. Citing the seven conditions of DOD's "potential interest", auditors are to consider whether the contractor includes activities not meeting this condition and if suspect, are to request a technical evaluation.

2. Auditors are to identify any development projects that may have entered the production phase. These production related costs are not considered IR&D and hence are to be eliminated from IR&D costs.

3. IR&D projects that have been incurring costs for a long time are to be identified and the auditor is to make an initial determination if demonstrable progress has not been made. In many cases, the guidance indicates this determination cannot be made without technical assistance. *(Editor's Note. We are unaware of a requirement to show "demonstrable progress" - this requirement appears to be an initiative of DCAA)*

4. Contractor contributions to cooperative research and development consortiums are to be reviewed to determine whether the costs should be considered IR&D or consortium costs that result from a company's participation in a cooperative venture of two or more companies authorized by the National Cooperative Research Act of 1984. Though many of the projects are truly IR&D and hence the contractor's contributions do qualify for IR&D status, other projects relate more to developing and producing products and services intended to be used in a contractor's own production facilities and these costs should be considered manufacturing and production engineering expenditures covered by FAR 31.205-25.

5. As the FAR requires, IR&D costs are to be accounted for in the same manner as contracts and hence are to include all related direct costs and allocable indirect costs.

Auditors are reminded that IR&D costs often benefit some profit centers and not others so in such cases those costs should be included in the G&A costs of those profit centers with the clear implication they should be eliminated from other profit center G&A pools. Auditors are reminded that contracting officers may approve use of a different base of allocations when allocation through G&A does not provide an "equitable cost allocation." The guidance follows up with the statement that auditors' determinations regarding allocation issues be should be included as part of its advisory report.

♦ Rules Under Other Agreements

Cooperative Arrangements. FAR 31.205-18 provides that the various cooperative arrangements contractors may enter into such as joint ventures, limited partnerships, teaming arrangements and various consortium agreements under a variety of recent government authorities (e.g. Stevenson-Wydier Technology Transfer Act, NASA Act of 1985, DARPA agreements) provides that the IR&D costs are to be allowable if the work performed would have been allowable as IR&D had there been no such arrangement. Under a NASA class deviation and later revision to FAR, contracts entered after May 1994 were allowed to have IR&D contributions made to NASA cooperative agreements treated as allowable IR&D costs.

Technology Reinvestment Projects. The TRP awards provide that government funds be matched by participants in each project in the form of cash, services or in-kind value of equipment including software and IR&D effort incurred after the TRP award. DCAA asserts that since TRP are administered by government agencies (e.g. DARPA) they are subject to FAR 31.205-18 and CAS 420. Hence, all IR&D assigned to the TRP project are allowable if they would be allowable without the TRP but if the contractor attempts to claim these same costs indirectly, then they are to be cited for a CAS 402 noncompliance. The auditor is told to review TRP costs to determine whether they are included as indirect IR&D costs to ensure they are disallowed.

FEDERAL SUPPLY SCHEDULES OR WHAT'S ONE OF THE BEST MARKETING TOOLS FOR THE FEDERAL CONTRACTOR

(Editor's Note. In spite of the proliferation of government use of the federal supply schedule program, we were surprised when we were reminded we have not provided our readers with an article describing the basics of the program. The intention of the FSS program is to meet the needs of the government quicker, more efficiently and cheaper by allowing the government to purchase commercial-like products and services at volume discounts while providing direct delivery to multiple buyers. For contractors, burdensome negotiated contracting is replaced by a simplified ordering approach reflected by substituting FAR Part 15 requirements with the simplified FAR Part 8 rules. Contractors can offer market as opposed to cost-based prices and dispense with obtaining numerous vendor quotes, often requiring price and/or cost analysis, and instead propose and order off a schedule. As we have done in the past we have asked one of our favorite colleagues, Kathy Szymkowics, to address this topic. As usual she brings her extensive experience as a contracting officer and consultant to provide an informative, lively and practical perspective. Kathy is the owner of The Acquisition Network (TAN) where she offers consulting and training services aimed at helping clients simplify doing business with the government. She can be contacted at (415) 861-0556 or www.TANetwork@hotmail.com for more information on this article.)

General Services Administration, Federal Supply Service (FSS) is the home of the famous GSA Schedules. Everyone has heard of these but unless you have one, you probably have only a vague notion of what they are. And if you knew what they were five years ago, you are behind the times. GSA Schedules are changing!

In the past, GSA Schedules were used for the purchase of supplies and commodity type products. Since 1996, FSS has expanded the schedules to include services. Some unexpected service Schedules include: professional engineering services (does not include Architect/Engineer services covered by Brooks Act or by Part 36 of Federal Acquisition Regulations (FAR)), auditing services, financial management services , management, organization, and business improvement services (MOBIS) and laboratory testing and analysis services. The list is expanding all the time.

Today, FSS helps Federal agencies throughout the world acquire supplies, furniture, computers, tools, equipment, and a broad range of commercial services. Once a contractor has a Schedule in place, he or she may sell directly to the Government buyer without further competition since the Competition in Contracting Act (CICA) requirements are considered fulfilled by the competitive process necessary to obtain the Schedule. This applies to only those items specifically listed on a contractor's Schedule and to any other incidental items that a buyer may want to add. Technically, in FAR language, the Schedule is a 'Multiple Award Schedule' or MAS.

The Schedule is also one of the better automation stories for the Federal Government. The '*GSA Advantage*!' site (www.gsaadvantage.gov) provides the ability to view all Schedules, the contractors under

each Schedule, and the price list for each contractor. The Government buyer (and the interested contractor) can look up prices, delivery schedules, contractor info and whatever else is needed to decide from whom to buy. The buyer can then place the order on the Net with his or her Government Purchase Card. The easier it is for the Contracting Officer to use that Schedule, the more business for the Schedule holder. It is the *GSA Advantage!* site that makes the schedule a marketing tool on its own.

While the smart contractor will still be out promoting the Schedule and not waiting for the orders to come on their own, this is one time when they actually might trickle in with no effort on your part. The Buyer who is looking for a particular product or service simply goes to the *GSA Advantage*! site, enters the zip code where delivery is required, punches in the special item number (SIN) or a description if the SIN is not known, and up comes a list of vendors. Of course, you want to make sure that when that Buyer looks at your items, they find the lowest price, the fastest delivery, and the easiest terms (such as the ability to use the Government Purchase card up to a higher limit than the micro-purchase threshold. Remember some contracting officers can make a $100,000 purchase on those little cards). An added advantage to the small or small disadvantaged contractor is that purchases by an agency from your Schedule count towards its socio-economic program goals.

So the basic purpose of the Schedule is to make a one-time competitive selection for multiple buys. But it can be more to the savvy contractor. Say you don't have a Schedule but are conducting negotiations with the Government for items that include some that are on a Schedule. You may use a Schedule price as justification for a price of another vendor listed in your proposal without the need to obtain multiple quotes. Because the Schedule price is a competed price, the Contracting Officer will accept it as reasonable based on that competition (even though it is the Schedule of a contractor that has nothing to do with this particular transaction). This can be a time (re: money) saver if the Schedules meet your requirements.

One thing to remember, however. All Schedules awarded since April 11, 1995 include an Industrial Funding Fee (IFF) in the prices listed. This fee is used for funding of the Schedule program by the using agencies. Contractors remit 1% of their total sales to the Government on a quarterly basis. GSAR Clause 552.238-76 is a part of all Schedule solicitations and explains the remittance requirement and procedure (yes, you really do need to read all of those clauses!).

♦ Steps in the Schedule Process

Many consultants make big bucks by advertising their ability to get you a GSA Schedule. Contractors pay thousands to take these classes and hire these experts. While I will be the first to promote a consultant when you need one (after all, that is how I make my living), the schedule process is relatively simple and GSA has made it one of the most accessible programs in the Government.

The first step in obtaining a GSA Schedule is the same as for any Government contract. You need to find that solicitation. Just like all federal opportunities over $25,000, it is announced in the Commerce Business Daily and at the FedBizOps (that is, the Federal Business Opportunity site, or www.EPS.gov). The difference with the FSS Schedule solicitation is two fold. First, it remains open for an extended period, usually one year. At that time, it may be extended for another year (and so on). Some Schedule solicitations actually say, "This solicitation will remain in effect unless replaced by an updated solicitation." Any time during the period that the solicitation is open, you may submit a proposal in response to the solicitation. GSA will have its own schedule for review in some cases, in others they simply review the proposals as received. The later system tends to take longer, for it is generally used when there is a big backlog of proposals to be evaluated. Expect a three to five month wait on your evaluation by GSA if no specific timeframe is given.

The second difference in the Schedule solicitation is that you are not competing against other contractors for an award. Once received, your proposal is evaluated against set criteria. The difference here is that you will be awarded a contract if you evaluate successfully against the criteria. You are not competing against other bidders. The result is the award of multiple contracts for a single Schedule. FSS Schedule 36IV – Document Management Products and Services, for example, has approximately forty contractors available on Schedule.

Each Schedule is divided into various Special Item Number (SIN) codes. Each SIN provides for a specific type of product or service. The proposer has the privilege (which sometimes looks remarkably like a curse) of specifying line items under the SIN. Thus

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the proposer can tailor the line items to fit the products or services the firm has to offer. The proposer can limit the geographic area to which deliveries will be made.

A new wrinkle is the 'just introduced' Corporate Contract. The Corporate Contract allows a firm (large or small) to place its entire product and service line under a single Multiple Award Schedule (the same basic vehicle as the regular schedule) without looking for a particular (or multiple) Schedule that describes the service. There is currently a solicitation open for this new contract that the Government envisions bringing new products and services to the Schedule process with lower administrative costs.

If the Contracting Officer finds deficiencies in your proposal (and there is usually *something*), you may be asked to make clarifications or changes to your proposal. The Contracting Officer will give a time and date for your submittal, and this timeframe is strict: meet it or you are out. Should you miss the submittal deadline, you may resubmit and start the process over from step one. Just be sure you make the changes identified as necessary by the Contracting Officer.

Once you have received that coveted Schedule, it will generally be in effect for a period of five years (though a specific solicitation may have other terms, as always, read the solicitation to be sure!) A recent change allows certain schedules, called "Evergreen Contracts" to remain in effect for twenty years!

One requirement you should know before ordering your solicitation. All GSA Schedule contractors are required to accept the government purchase card for purchases up to the micro-purchase threshold. Contractors are encouraged to accept the purchase card as payment for orders up to the customer agency's limit. Without the capability to accept these credit cards, you will be rejected.

Another excellent use of schedules is for meeting the small and small, disadvantaged business goals of the large business's subcontracting plan. The use of a Schedule for office supplies held by an 8(a) contractor can contribute significantly towards the designated goals. That's right, often a contractor doing Federal work can obtain approval to use the GSA Schedules for supplies or services needed in the performance of the Federal contract.

Want more information? GSA gives you more than you may ever need at http://www.fss.gsa.gov/. Or call me!

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