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Knowing Your Cost Principles… SEVERANCE PAY

(Editor's Note. As part of our continuing series on exploring a cost principle, we have selected a topic we are seeing government auditors paying particularly close attention to. We will present the general rules and add guidance the Defense Contract Audit Agency asks its auditors to follow when the guidance adds information not contained in the general rules. The source of this article is several texts we often use, the Defense Contract Audit Agency Manual (Chapter 7-2107) and a recent consulting engagement we had with a client whose severance costs were questioned by DCAA.).

General Rules

FAR 31.205-6(g) covers severance costs. Severance pay or dismissal wages are extra payments made to employees whose employment is involuntarily terminated. DCAA guidance provides for two types of "involuntary" termination: (1) where the employee has no option of staying with the company and (2) where the company has an established goal for a reduction in work force. In the second case it is irrelevant whether a specific employee is given an option but only requires a commitment to reach certain employment goals with the assurance that the severed workforce will not be replaced. Evidence of a commitment to workforce reduction would need to show that terminated employees will not be replaced i.e. their jobs have been abolished. The guidance recognizes that under the second circumstance, where severance costs are accompanied by a termination plan, the expenses may be higher than the established plan but would still be allowable if reasonable. Payments for voluntary terminations are unallowable.

Severance payments do not include payments under early-retirement incentive plans. Severance pay is normally allowable to the extent it is required by law, employer-employee agreement (including an unwritten established policy that implies an agreement) or circumstances of a particular employment (for example, a special employment agreement with an individual employee).

Payments made to employees who preserve credit for prior length of service by going to work for a replacement contractor or by going to work for an affiliated company of the contractor or at another facility of the contractor are not allowable. However, even these provisions may be overcome by a proper contract clause or special agreement that requires reimbursement by the government.

Normal and Abnormal Severance. "Normal severance" generally refers to routine employee terminations while "abnormal severance" refers to any mass termination of employees. Actual costs of normal severance must be allocated to all work performed at the facility where the severance costs were incurred. Accruals for normal severance pay are acceptable if (1) the amount is reasonable in light of prior experience and (2) it is allocable to both government and non-government work. Abnormal severance is unallowable as an accrued cost because it is considered speculative. However, the government may consider allowability of actual payments for mass terminations on a case-by-case basis. Appeals board decisions have ruled that this provision does not grant a contractor a price adjustment on a fixed price contract that did not contain specific terms allowing abnormal severance costs. However, an advanced agreement may be developed on how to handle mass terminations should they occur.

Golden Parachutes and Handcuffs. In 1988, FAR 31.205-6 was revised to disallow costs of a "golden parachute" (pertaining to employees who leave the organization) and "golden handcuff" (pertaining to employees who stay with the organization) arrangements. These terms refer to employees' compensation in the event of a corporate merger or change in management control of an organization. Special compensation to terminated employees after change in management control is unallowable to the extent that is exceeds normal severance pay. Special compensation contingent on the employee remaining

with the organization after a change in management control is also considered unallowable.

Allocation. In *Aerojet-General Corp*. (ASBCA No. 34302), the government challenged the allocability of severance pay costs. In preparing for the final year of operation of a business unit the contractor enhanced its severance pay policy to retain employees to complete two remaining cost reimbursement contracts. The government argued the severance pay should be allocated to the final two years of operation because two fixed price contracts completed in the next to last period also benefited from these expenses. Relying primarily on CAS 406 that establishes the appropriate accounting period, the Board concluded the costs were properly assigned to the last fiscal year concluding that severance pay costs were allocable to the year they were actually incurred.

WARN Act. The Worker Adjustment and Retraining Notification (WARN) Act requires certain employers to provide a 60-day notice to employees before a layoff. When the Act applies (e.g. at least 100 full time employees, at least one site shutdown, at least 33 percent of the workforce terminated) many contractors will put the laid off employees who hold sensitive positions on administrative leave for the notice period so they do not run the risk of retaliation from employees who are laid off. These costs are normally allowable if the employees are considered "high risk." DCAA guidance puts the burden on the contractor to demonstrate why the employees are "high risk" and cannot be reassigned elsewhere.

Foreign Nationals. Severance pay to foreign nationals for services performed outside the United States are unallowable to the extent those payments exceed amounts typically paid in the US. The "typical" amount is based on providing similar services in similar industries. Costs that are otherwise allowable are unallowable when termination of employment is a result of a facility closing or reduction at the request of that government. When the closing or reduction is a result of a country-to-country or a status-of-forces agreement the severance expenses are allowable if the head of an agency or their designee may allow the costs. Contractors should be alert for special contract clauses that may impact severance costs especially under circumstances where foreign nationals are used. For example in *T.E.A.S.A*. (ASBCA 43844) the Board held the contractor was not entitled to severance costs paid for nationals when a follow-on contract severed the foreign nationals because of a clause in the contract entitled "Severance Pay Resulting from Reduction in Scope of Contract."

Severance vs. Early Retirement. Early retirement plans are addressed in a separate FAR 31.205-6(g)(7) section and is defined as a plan where employees receive a bonus or incentive, over and above the requirement of the basic pension plan to retire early. Sometimes government representatives will, inappropriately in our opinion, consider such early retirement costs as severance costs and lump such payments into the category of severance expenses and thereby question excess amounts. The referenced FAR section states though the costs are not really pension costs because the plan does not apply to all employees and is not a "present life income settlement," early retirement incentive payments still must follow pension cost criteria set forth in FAR 31.205-6(j)(3)(i) through (iv). Prior to 1988, the FAR provided that severance payments or amounts paid in lieu of them are not allowable when paid to employees in addition to early or normal pension payments. This prohibition was deleted and since October 1988 the FAR now permits the payment of otherwise allowable severance and pension benefits concurrently as well as sequentially (i.e. the contractor may delay pension benefits until severance pay is exhausted). Auditors are told to carefully review such plans for reasonableness that allow both payments.

Other DCAA Guidance

Types of severance expenses. DCAA guidance informs auditors that a severance policy normally pays employees a set number of weeks' pay based on years of service. It also recognizes contractors may offer additional termination benefits such as medical care, education and relocation expenses to reduce hardship of separation which it also includes under the severance terms. It specifies such severance payments must be "reasonable" and opens the door to use of surveys to evaluate this reasonableness against compensation practices of other firms in the same industry as well as those engaged in non-government work.

Reasonableness of special termination plans. Contractors may offer special termination plans that offer enhanced benefits but result in overall savings by inducing voluntary employee terminations. DCAA recognizes the benefits of such special termination plans and stresses for these costs to be "reasonable" and hence allowable in accordance with FAR 31.205-

6(b)(1) and FAR 31.201-3, the contractor should be able to demonstrate the benefit of such expenses exceeds the costs. Examples of such benefits might include lower overall compensation of remaining employees by keeping lower paid employees who will stay on longer or lower training and recruiting costs due to not having to hire new employees. Though it recognizes the validity of "intangible benefits" (e.g. employee morale, contractor's reputation as an employer), DCAA indicates such claimed cost savings should be preceded by an advanced agreement with the CO.

General release agreements. In 1995 the DCAM issued guidance advising auditors that costs related to obtaining employee general release agreements – agreements with terminated employees that release the contractor from demands and claims related to discrimination laws. The rationale for this guidance was that the payments were not for services actually rendered. Following much criticism, the guidance was cancelled and replaced by a policy to review the costs of such agreements on a case-by-case basis to assure the costs are reasonable.

Case Study

(Editor's Note. We believe the following case is quite instructive because it provides lessons on how to phrase policies and procedures, demonstrates the need for employment agreements if they differ from stated policies, highlights the need to closely examine surveys used by the government since they provide numerous types of interpretations to support a given position and finally, the need to have a back-up compromise position.)

♦ Background

When the company decided to relocate corporate headquarters from San Francisco to Denver, Contractor negotiated a severance agreement with two senior executives (Chief Financial Officer and President of a key business unit) that provided for one year of salary plus miscellaneous expenses such as accrued vacation, various post-severance expenses, outsourcing resources, etc. DCAA questioned one half of the salary expenses and all the additional severance related expenses asserting the severance expenses were unreasonable because (1) the amount of severance pay was contrary to the company's written policies and procedures that limited severance benefits to one week of salary for each year of employment (2) there was no separate employment agreement between the company and employees that waived this policy and (3) a survey comparing comparable firms limited severance pay to two weeks of base pay for each year worked while another part of the survey capped such payments to 26 weeks of salary. DCAA compared the entire severance package with the equivalent of 26 weeks of base salary and questioned the difference as "unreasonable". When we asked what survey they alluded to and asked for a copy, DCAA responded that the survey was by the Lee Hecht Harrison firm but refused to provide a copy of the survey stating it was against DCAA policy to provide them.

♦ Response

Response to DCAA's first two points were quickly disposed of. Though Contractor's written policy on severance payments did limit severance pay to one week of salary for each year worked the policy clearly stated "the firm reserves the right to make exceptions to the severance pay policy at its sole and absolute discretion." As for the absence of an agreement between the company and terminated employees, a copy of the agreements that provided for the severance payments were found and provided to DCAA.

The remainder of discussions with the government revolved around the survey. Though Contractor used several surveys for benchmarking salaries and wages it had no access to any surveys benchmarking severance payments. We located the survey DCAA alluded to on the internet which was entitled "Severance and Separation Benefits – An Update to our Severance Study" which DCAA confirmed was the document they used in questioning Contractor's expenses. We closely examined the 26 page survey summary, found several discussions that contradicted DCAA's conclusions and reported these differences to DCAA. For example:

1. The survey addresses base severance payments and considers other elements of compensation (e.g. paid vacations, outsourcing, various post-severance expenses, etc) separately. Hence the employees' base salary, not total severance payments, should be benchmarked.

2. The 26 weeks the survey indicates is the "median maximum severance amount" applies to all employees of the companies surveyed. Since the two individuals were both officers and senior executives of the company, it is appropriate to evaluate their compensation against individuals in the same or

similar positions, not all employees "for all levels." Hence, more than 26 weeks should be appropriate.

3. In the same paragraph that DCAA used to justify the two weeks of salary for each year worked, the following sentence provided the amount of time for officers and executives should be four weeks – "median minimum severance amounts of four weeks for officers and executives" – not two. Applying the four week for each year worked standard, both executives were entitled to a little over one year's salary.

4. The survey stated that severance payments, particularly for officers and senior employees are usually not limited to years of service but rather negotiated on a case-by-case basis – "many organizations base severance on more than a single factor, with years of service generally being one element in the formula…the higher the level of employee, the less likely it is that severance will be based on years of service only." The severance agreement provided for their continued services until replacements could be found in Denver. This benefited the government and hence was worth a premium to keep their valuable services in-house rather than being picked up by other firms in the tight executive labor environment of the internet era Bay Area.

During the discussions DCAA put forth the position that the severance payments plus other compensation exceeded the Office of Federal Procurement Policy executive compensation ceilings and hence they were considering questioning additional amounts. We were able to avert this by demonstrating that OFPP definitions of compensation (and even those identified in the DCAA Contract Audit Manual) do not include severance payments in their definition of compensation.

♦ Conclusion

DCAA and Contractor continued the dialogue and when it was clear neither DCAA nor Contractor would change their positions the parties went to the contracting officer to see whether it could be resolved. He indicated, informally, though our position was strong he did not want to totally reject DCAA's position and sought a compromise. Contractor identified a section in the survey that provided that officers of companies received, on average, 42 weeks of severance and after asking for evidence they were officers as well as senior executives, the CO agreed that they would be entitled to 42 weeks of their salary plus the additional payments. All parties agreed to the compromise.

CONTRACT DOCUMENTATION

(Editor's Note. We are constantly reminded, whether it involves a contract dispute, performance assessment or successful claim or termination resolution, about the importance of good documentation. The burden of asserting and proving facts usually falls on the contractor, not government. The contractor must usually prove what was said or done, what cost was incurred, etc. Carefully documenting important items without getting lost in an avalanche of paper is critical. We asked a colleague of ours, Tim Power of the Law Offices of Tim Power in Walnut Creek, CA to provide our readers with some sound practical advise on documentation. We asked Tim because he is one of the most successful people we have encountered in pursuing claims and terminations for his clients.)

Studies have pointed to an interesting conflict – government contracts usually require much more paperwork and administrative effort on the one hand yet effective communication and timely resolution of problems between contractors and clients are usually handled better in the private sector. Tim believes that emphasis on the right documentation during the entire contracting cycle is critical.

Bidding Phase

Some of the most important documentation requirements during this phase relate to requests for clarification during the bidding process since only written clarifications are binding. Requests for clarifications should be made in writing and kept in a file with any related correspondences. If telephone calls are used, notes should be kept about the call and retrieved. Be sure to write a memo to the agency confirming the main points of the telephone conversation. Ask to receive clarification in writing or by fax. Tim says he could not count how many claims were lost because there were unclear specifications but the contractor failed to show it questioned specifications during the bidding stage. Though it is not the contractor's responsibility to rewrite faulty specs it is the contractor's obligation to bring up discrepancies or ambiguities that are obvious before bidding and allow the CO to correct them.

For example, a contractor lost his claim for the higher cost of using new parts rather than reconditioned parts because he did not ask the CO before bidding if reconditioned parts could be used. The confusion should have been resolved during the bidding process and documentation of this effort demonstrated.

Though there is no requirement that bid and proposal worksheets be retained after a bid is submitted they should be kept. If a contractor asserts there was a mistake in its bid and wants to correct it, the worksheets are usually needed to show what mistakes were made, how it was made and what was the correct bid amount. If a claim is filed, it is often important to show what costs for the original work were anticipated and which costs were included in the bid even when the contract price is not cost-based. If you win a protest, the GAO may likely allow recovery of original bid and proposal costs if they are documented. Alos, under a termination for convenience, start up costs may be recovered.

(Editor's Note. In a recent termination for convenience settlement dispute we were involved with the one year with four option years contract was terminated six months into the first year. Government auditors questioned most of the special equipment costs our client was claiming, stating the amortization period for such costs should have been only one year. We were able to successfully challenge these questioned costs by showing the contractor used a five year amortization period for bidding purposes, asserting it was patently unfair for the government to receive the benefit of spreading the costs over five years for pricing purposes and then allowing only half of the costs (six months of a one year life) for purposes of termination recovery.)

Performance Phase

A contractor, not the government, has the burden of proving all elements of a claim so it is necessary to prepare and keep documents during performance that will support any potential claims that may arise. For instance, if there is a delay, the contractor must show it was beyond its control. If it asserts the government caused the delay, the contractor must show what caused the delay and that the CO or authorized representative was responsible for it. In most such delay claims, it falls to the contractor to show what happened during performance. Since it is usually not always known if there will be a claim or what will be needed later, contractors need to develop a routine system to document performance that meets their individual needs. Tim provides some examples that may be relevant to your needs:

1. A claim for additional costs caused by the lack of heat in a building was successful because the contractor could show that the same crew did the same work in a similar building in half the time. Daily reports showing where each employee worked were used to challenge the government's assertions that different crews worked in the various buildings.

2. Key field personnel should keep a diary where they may record observations along with their reports. These observations might include telephone calls, material deliveries, comments by inspectors and subcontractors, etc.

3. Documentation of differing positions should be kept when possible. Numerous forms, often required by the contracts, such as daily reports, quality control reports, inspection reports have room for contractor comments and disagreements should be noted on them. Failure to make comments are often interpreted as proof no disagreements existed. Contractors, especially more inexperienced ones, should resist inclinations to not want to challenge inspectors.

4. The numerous responses to COs need documentation efforts. Examples include confirmation of inspectors' directions, requests to clarify ambiguous directions, requests to clarify whether acceleration is expected, etc.

5. Telephone and verbal directions are common on government contracts. All conversations with government representatives need to be documented, especially directions and clarifications from the field. This can often be a simple confirmation memo with the date of conversation and short report on what was discussed. Files of these memos should be maintained.

6. The lines of authority specified in the contract should be followed where directions are confirmed with the proper authorized contract administrators. Tim mentions that he has encountered numerous instances where claims for changes resulting from inspectors' directions were rejected on grounds they had no authority to make a change and the contractor did not tell the CO about the direction until the work was done. If the contractor told the CO about its disputed directions and the discussions/written notice was documented then the CO would have confirmed the directive and there would have been a bona fide change or the CO would have overruled the directive and the extra work would not have been required.

7. Meeting notes should be typed up and distributed to participants at the meeting. The ACO, if not present, should receive a copy. A distribution list should be on the meeting notes. However, in-house meeting notes should be for office distribution only so as to encourage personnel to speak freely on any possible topics of the contract.

8. Various logs should be kept. For example, logs for Requests for Information should note the date the information was requested and the date received while logs of shop drawing approvals should be kept, noting dates sent, dates received and actions taken.

9. Taking photographs or videos is a good way to document performance. Pictures are the best way to show the conditions described in inspection reports. For example, a claim for improper deductions was successful because a contractor's photos showed the overall work was proper. On another claim for improper deductions on an Air Force base maintenance contract, dozens of pictures of the grounds were taken documenting how the base looked. The photos were numbered and placed on a map to show where they were taken which allowed the contractor to demonstrate the government's negative inspection reports were excessively selective, representing only a few small areas rather the general level of work.

Completion Phase

Since employees may leave or, in service contracts, work for the successor contractor, key management and field personnel should write an evaluation of work performance. They should be asked to write down their perceptions and what they see as potential problem areas on future contracts with the same agency. This should mitigate the common tendency for potential witnesses to tell a different story once they leave or work for the successor contractor.

For example, a claim for government interference with performance on a service contract was almost lost because the former project manager changed his position when hired by the follow-on contractor. During performance the manager claimed government interference harmed performance and wrote memos about the interferences. When the same manager was hired by the follow-on contractor and was dealing with the same inspectors he changed his position. His memos showed his true feelings but getting a statement about the problem when he was still an employee would have helped more.

Conclusion

Careful documentation is the least expensive thing a contractor can do to protect itself from loss and often provides great payback. If a claim is filed, well organized clear records will help establish the basis and amount due. Time spent later organizing documents and interviewing employees to try and piece together what happened is expensive and inaccurate. It is often impossible to reconstruct what happened, resulting in lost income opportunity from failing to convince a CO your position is justified.

Keeping documentation should become a routine. Peoples' memory fades, they move on and even die making claims difficult to prove. Keeping "better" rather than "more" paperwork can mean the difference between recovering a claim or taking a loss on a contract because there is inadequate support.

JUSTIFICATION OF ONE OVERHEAD RATE AT MULTIPLE LOCATIONS

(Editor's Note. Whether you are cutting back or expanding or your strategies in the government marketplace have changed, its usually a good idea to examine your indirect rate structure on occasion to see whether its time to change the way you allocate indirect costs to your government contracts and subcontracts. In the third quarter 2001 issue of the DIGEST we wrote about a challenge to DCAA's assertion that a professional services firm should establish multiple overhead rates by location and argued that a single company-wide overhead rate was appropriate. Since then many of our subscribers in manufacturing firms have asked us the relevance of that issue to them and we put the question to Len Birnbaum of Birnbaum & Associates. He provided us with a position paper he wrote for a manufacturing government client he represented in response to a DCAA opinion that multiple rates for different locations should be established. Len is one of the imminent consultants and attorneys in the government contracting field and we find his positions in support of clients to be excellent examples of how to effectively challenge positions taken by the government. The following meets our desire to present our readers with real life challenges to government positions on cost allowability and allocation issues.)

Government auditors have long held a strong preference for contractors to establish separate overhead rates for various locations, especially when their analysis indicates such practices would benefit

the government. They often present arguments that more distinct overhead rates more accurately represent the costs incurred by contracts at those locations and they commonly put forth arguments that the varied overhead pools represent more "homogeneous pools" and the resulting rates provide better "causal/beneficial" relationships. We believe government contractors should decide what indirect structure best meets their objectives (e.g. maximize recovery on certain contracts for greater revenue, minimize recovery to meet competitive pressure, provide least administrative effort) and then consider resisting government efforts to alter those decisions.)

Background

Contractor has two facilities. In Facility 1, employees predominately engage in research and development, program management, contract administration and general and administrative activities. Prior to 1998, this is where the contractor conducted all of its operations since the company's inception in 1989. Facility 2, started in 1998, is dedicated to manufacturing operations. Since Facility 2 is new, it incurs a significant portion of the company's depreciation expenses. It also incurs abut 86% of the firm's direct labor which is the base in which overhead costs are allocated.

Contractor's largest contract is a cost share contract with the Department of Energy. Of the total depreciation expense of $1,265,400, 47.3 percent or $552,648 was deducted from the overhead pool because it was considered a direct cost of the cost sharing contract due to the designation of the equipment as cost sharing in support of the DOE contract.

Audit Position

DCAA's position is that the current method of allocating overhead expenses (particularly depreciation expenses) using one overhead rate causes developmental contracts to absorb a disproportionate amount of indirect costs since the direct labor costs of such contracts are incurred primarily in Facility 1 whereas the bulk of depreciation expense is incurred in Facility 2. The current system results in an "inequitable" distribution of costs where there is no "causal/beneficial relationships between the indirect expense and the direct labor activity." Consequently, the contractor should be required to segregate its overhead expenses into two separate "homogeneous expense pools" at each facility starting in fiscal year 2000.

DCAA cites FAR 31.203(b) and 31.203(d) in support of its position. The relevant sections in FAR 31.203(b) states "Indirect costs shall be accumulated by logical cost groupings with due consideration of the reasons for incurring such costs. Each grouping should be determined so as to permit distribution of the grouping on the basis of the benefits accruing to the several cost objectives…The base should be selected so as to permit allocation of the groupings on the basis of the benefits accruing to the several cost objectives." FAR 31.203(d) states that the cost accounting standards should govern if a contractor is CAS covered and otherwise, generally accepted accounting principles should dictate accounting treatment. The method of allocating indirect costs may require examination when (1) "substantial differences occur between the cost patterns of work under the contract and the contractor's other work (2) significant changes occur in the nature of the business, extent of subcontracting, fixed-asset improvement programs, inventories, volume of sales and production, manufacturing process, the contractor's products or other relevant circumstances or (3) indirect cost groupings developed for a contractor's primary location are applied to offsite locations".

Len's Response

Assessment of the Facts. The contractor conducted its manufacturing operation at both facilities during FY 2000 and in the second quarter of 2001, it moved most of its manufacturing operations to Facility 2. While Facility 1 is designed for R&D effort going forward, Facility 2 includes both manufacturing and R&D effort. The contractor's DOE contracts require a manufacturing facility to qualify for award. These contracts include tasks that specify process, product and performance improvements of manufacturing operations and products. These tasks cannot be accomplished in Facility 1 since it does not have the requisite manufacturing capability.

Therefore, there is a direct relationship between the indirect expenses the contractor accumulates and its labor activity since the developmental DOE contracts are conducted at Facility 2. Consequently, these expenses should be included in one cumulative overhead rate calculation as proposed.

Response to DCAA's FAR Citations. DCAA's recommendations infer that FAR 31.203(b) and FAR 31.203(d) supports its position that in order for an expense pool to be homogeneous separate pools *must*

be created. This is not correct. First, the cited regulations do not use the term "homogeneous expense pools" nor do they state separate manufacturing pools must be established for each location. FAR 31.203(b) provides, in part, "the base should be selected so as to permit allocation of the grouping on the basis of the benefits accruing to the several cost objectives." Though FAR 31.203(d) provides that multiple overhead rates *may* be adopted, there is no stipulation they must be created. Further, GAAP does not address the number of overhead pools that need to be created.

Len states the contractor is not CAS covered but suggests that CAS 418 does provide useful guidance with respect to defining homogeneous indirect cost pools. Citing an authoritative text (Accounting for Government Contracts, Cost Accounting Standards by Lane Anderson) for assessing the homogeneity of an indirect expense pool, the following four things must be considered:

1. The cost in the pools should represent activities having commonality of purpose.
2. The cost pools should be a logical group of costs.
3. The allocation base should have a direct causal relationship to the costs in the pool into the cost objectives.
4. Diversity of products (final cost objectives) should be minimal for each cost pool.

Len concludes the contractor's use of a single overhead rate is in conformance with these four requirements.

The Litton Case. The Armed Services Board of Contract Appeals in *Litton Systems Inc. Guidance and Controls Systems Division* (ASBCA No. 37131) resolved homogeneous pool issues of a major contractor that used a composite overhead pool for two divisions in different geographic areas. The Board stated "the standard does not mention the location of cost incurrence as a relevant factor, nor is it relevant from a purely conceptual view…Nothing in CAS 418 or any other Standard indicates that location of facilities or cost levels of operation has any effect on the characteristics of homogeneity of indirect cost pools as described in CAS 418.50(b)(1)."

Len lastly cites the Cost Accounting Standards Board, Summary of Objectives, Policies and Concepts (May 1992). In that piece, homogeneity is a matter of degree. Homogeneity exists if the costs or functions allocated by a single base have the same or similar relationship to the cost objectives for which the functions are formed. This is certainly true in this instance.

Len concludes that use of a single overhead rate conforms to regulations, authoritative reference material and case law.

NEW CLAUSE FLOW-DOWN REQUIREMENTS

(Most subcontract agreements we examine are outdated, based on a models developed as far back as 1984. They are boilerplate agreements that do not reflect recent changes to the Federal Acquisition Regulations – in particular, all FAR mandatory "flow-down" clauses (clauses in prime contracts that must be included in all first tier subcontracts and usually lower tier). We have just obtained a third edition of the Committee on Federal Subcontracting Section of Public Contract Law group of the American Bar Association's "Guide to Fixed Price Supply Subcontract Terms and Conditions". It is intended to assist both prime contractors and subcontractors draft subcontracts for fixed price supply contracts (though it explicitly applies to "supply contracts" our inquiries to two members of the committee who wrote it said it generally represents good guidance for labor service contracts also). This is an update to the second edition of the guidance we wrote about in the Third Quarter of 1998 and generally represents an expansion of mandatory flowdowns over the earlier version.)

The Committee has identified all mandatory clauses as well as a limited number of clauses that are not mandatory yet the Committee believes are necessary. The publication identifies the clauses for both governmentwide and Department of Defense use, provides full text of them, offers other provisions that parties may want to consider including and subcontracting clauses for commercial items. We will limit this article to listing the new mandatory and recommended FAR clauses as well as the new, limited requirements for commercial items. You can receive the publication for $45 plus $4.95 handling by calling the ABA Service Center at 1-800-285-2221.

The following provisions are now *mandatory* FAR Clauses:

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

52.203-7, Anti-Kickback Procedures. Applies if order exceeds $100,000.

52.204-2, Security Requirements. Applies if subcontracts involve access to classified information.

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

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

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

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

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

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

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

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

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

52.222-21, Prohibition of Segregated Facilities.

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

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

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

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

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

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

52.225-13, Restrictions on Certain Foreign Purchases.

52.227-1, Authorization and Consent.

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

52-227-9, Refund of Royalties.

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

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

52.245-18, Special Test Equipment.

52.246-16, Responsibility for Supplies.

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

The following clauses, though not mandatory, are considered *necessary* to ensure that the prime contractor can perform its obligations to the government or that some critical right or obligation of the Buyer, Seller or the Government is protected.

52.211-5, New Materials

52.211-15, Defense Priority and Allocation Requirements

52.214-27, Price Reduction for Defective Cost or Pricing Data – Modifications – Sealed Bidding. Applies to prime contracts awarded by sealed bidding.

52.215-10, Price Reduction for Defective Cost or Pricing Data. Applies if prime contract was awarded through negotiations, cost or pricing data and a Certificate of Current Cost or Pricing Data was presented (not required unless contract or subcontract exceeds $550,000).

52.215-11, Price Reduction for Defective Cost or Pricing Data - Modifications.

52.219-8, Utilization of Small, Small Disadvantaged and Women-owned Small Business Plan. This is not applicable to small business concerns.

52.219-9, Small Business Subcontracting Plan. Not applicable to small businesses.

52.225-1, Buy American Act – Balance of Payments – Supplies. Applies if order exceeds $10,000.

52.225-3, Buy American Act – Trade Agreements – Balance of Payments Program

52.225-5, Trade Agreement.

52.225-15, Sanctioned European Union Country End Product.

52.227-14, Rights in Data – General.

52.229-3, Federal, State and Local Taxes.

52.233-3, Protest After Award.

52.242-15, Stop Work Order.

52.242-17, Delay of work.

52.243-1, Changes – Fixed-Price.

52.245-2, Government Property (Fixed-price Contracts).

52.246-2, Inspection of Supplies – Fixed Price.

52.246-16, Responsibility for Supplies.

52.249-2, Termination for Convenience – Fixed Price. Note this clause has been revised: Paragraph (a) "the government may terminate…" has been changed to "the buyer may terminate"; Paragraph (c) changed from 120 days to 60 days; Paragraph (d) plant clearance procedure is omitted; Paragraph (d) changed the time for submission from "1 year" to "6 months" and; Paragraph (k) the time for submitting an equitable adjustment proposal after a partial termination is changed from "90 days" to "45 days."

52.249-8, Default (Fixed-Price Supply and Service). Note this has been revised: Paragraph (a) the cure period has changed from "10 days" to "7 days."

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

52.222-26, Equal Opportunity.

52.222-35, Affirmative Action for Special Disables and Vietnam Era Veterans.

52.222-36, Affirmative Action for Handicapped Workers.

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

52.212-4, Contract Terms and Conditions – Commercial Items.

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

Q&A ON IMPACT OF RECENT GAO DECISIONS

(Editor's Note. We frequently report on significant protest cases to better understand how source selection decisions should be made. The General Accounting Office is responsible for hearing protests and hence we find their decisions useful in how to more effectively present an offer and how source selection officials should be evaluating them. Many of these decisions are couched in legalese so we were pleased to come across an authoritative article that translates some of these recent GAO decisions into clear, practical-oriented language. The following is based on an article by Michael Golden, Assistant General Counsel with the U.S. General Accounting Office in the July 2002 issue of Procurement Law Advisor.)

The author presents his material in a question and answer format and we found it quite effective so we decided to follow the same format.

Questions: True or False

1. In a commercial acquisition using simplified acquisition procedures, a CO need not disclose the relative weights of the evaluation factors to be used in evaluating offerors.

2. Price or cost to the government of competing offers/proposals must be evaluated in every source selection.

3. In the case of a vendor without a record of relevant past performance, the agency may evaluate the vendor unfavorably.

4. When using oral presentations, an agency must maintain a record of these presentations.

5. An agency may downgrade a firm's offer/proposal under the past performance evaluation factor because the offeror has a history of filing claims or bid protests.

6. If an agency orders from the Federal Supply Schedule (FSS), it may buy incidental, non-FSS items under the same order.

7. Under an FSS buy, the agency does not need to synopsize the requirement, state evaluation criteria, or hold discussions.

8. An agency must limit its evaluation of past performance information to the information submitted by the vendor in its proposal.

9. Cost realism and price realism do not mean the same thing.

10. Under sealed bidding procedures, an agency may request technical data packages, evaluate these data packages, and conduct comparative evaluation of bidders' response for purposes of selecting the best value.

Bonus Questions. In establishing the competitive range, the CO may eliminate a number of proposals because, in the contracting officer's judgment, there are too many proposals to consider.

Answers to the GAO Quiz:

1. **True**. Generally, procurements using simplified acquisition procedures are exempted from the requirement in FAR Part 15 that the relative importance of evaluation factors be disclosed. However, the GAO has ruled that when using simplified acquisition procedures, which are described in FAR Part 13, the procurements must be conducted in a fair and equitable manner. It concluded that when an agency failed to disclose in the request for proposals the relative weights of the evaluation factors, the offeror was denied one of the basic tools used to prepare written, detailed proposals and hence the procurement was not fair and equitable (*Finlen Complex Inc.*, B-288280).

2. **True**. Price or cost to the government of competing proposals must always be evaluated.

3. **False**. When the offeror does not have a record of relevant past performance or the information on past performance is not available, the offeror may not be evaluated favorably or unfavorably on past performance (FAR 15.305).

4. **True**. FAR 15.102(e) provides that the contracting officer must maintain a record of oral presentations to document what the government relied upon in making their source selection and the absence of that record is grounds for overturning a selection. However, the method and level of detail of the record (e.g. videotaping, audio tape recording, written record, notes or copies of offerors' briefing slides, presentation notes) is at the discretion of the source selection authority.

5. **False**. Absent some abuse of discretion in resolving contract disputes or bid protests, contracting agencies should not lower an offeror's past performance evaluation based solely on the fact the firm has filed claims or protests. A firm should not be prejudiced in competing for other contracts because of its prior reasonable pursuit of such remedies.

6. **False**. If an agency uses the FSS, the agency must ensure it is indeed buying items on the FSS. GAO ruled an agency cannot rely on an "incidentals" test to justify purchases on non-FSS items in connection with a FSS buy; where an agency buys non-FSS items, it must follow applicable procurement regulations. There is no authority to purchase both non-FSS and FSS items as part of a system using FSS procedures (*Pyxix Corporation*, B-282469).

7. **True**. The ordering procedures established for the FSS program satisfy the statutory requirement for full and open competition if (1) participation in the program has been open to all responsible sources and (2) orders under these procedures result in the lowest overall cost alternative to meet agency needs. Therefore, when placing an order under the FSS, an agency is not required to seek further competition, synopsize the requirement, or make a separate

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determination of fair and reasonable pricing since the planning, solicitation and award phases of the FSS satisfy these requirements. Be aware, however, in the wake of recent public criticism of non-competitive award of task orders under multiple award contracts and recent changes to the FAR, procedures for specific orders will likely become more competitive under FSS programs.

8. **False.** Unless the solicitation provides otherwise, an agency may evaluate past performance information obtained from sources other than the offeror. Ordinarily, a firm should expect that agencies would go outside the contracts it list in its proposal to obtain past performance information. It is good practice for agencies to advise its offerors in the solicitation that they will consider information from any source concerning an offeror's past performance.

9. **True.** A frequent problem arises when an agency confuses cost realism with price realism. If an agency solicits on a fixed price basis, a price analysis is appropriate and that price analysis is generally limited. A fixed price contract is not subject to a realism adjustment. When agencies incorporate cost realism type language in fixed price solicitations, they invite protests on the grounds the agency did not perform the promised cost realism.

10. **False**. Under sealed bids, an agency must award a contract with reasonable promptness to the responsible source whose bid conforms to the solicitation and is most advantageous to the government, considering only price and other price-related factors included in the solicitation. After evaluation of price, the only other appropriate inquiry is that of responsibility. Consequently, requiring and comparatively evaluating technical submissions is inconsistent with sealed bidding procedures.

Bonus: True. Under FAR 15.306, a CO has the authority to limit the number of proposals to be included in the competitive range to the greatest number that will permit an efficient competition among the most highly rated proposals, but only if the underlying solicitation contains the required notice.

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