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Classic Oldie…

TACTICS TO LOWER BID PRICES

(Editor's Note. Since most subscribers came aboard in latter years, we have decided to feature earlier articles, updated with new insights, that we believe will be useful to our readers. In the next few issues we will focus on pricing topics. Though much of our consulting activity used to focus on ways to ***increase*** *cost recovery, the tougher competitive government market has changed some of our efforts to help clients* ***lower*** *their price proposals. Since a key to a successful proposal is to anticipate what your competitors may offer, the following common pricing tactics may be used by other offerors or you may want to consider them for yourself. We have incorporated some of the ideas of Brian Fischer in the May 1997 issue of Contract Management and added some of our own.)*

Some of the tactics we discuss below represent real overall cost savings to contractors while others merely shift costs away from the proposed contract being sought.

1. ***Shift average direct rates to lower end of the spectrum.*** Rather than using an average rate for a given labor category (or even the higher end citing the need for more years of experience, for example), price rates at the lower end with the intention of hiring new employees or using lower paid employees on the contract.

2. ***Use and bid uncompensated overtime.*** Lower the hourly rate by dividing the yearly or monthly salary by a number larger than the normal 40 hour work week with the intention of having salaried employees working more hours. Remember that protests are common when only some offerors bid uncompensated overtime but they have rarely been successful when the uncompensated overtime is not excessive.

3. ***Propose a low or negative escalation rate.*** For out years, most current labor rates and other costs are multiplied by an escalation factor supplied by such firms as DRI McGraw Hill. In price sensitive competitions, proposing a low or negative rate can be highly favored by selection personnel. Common ways of achieving these low escalation rates include (a) promoting employees over the contract period from lower to higher paid categories while hiring new employees at the floor level (b) proposing as a base rate an estimated average rate over the period of performance or (c) freezing wages.

4. ***Hire "temporary" or "variable" employees.*** Increasingly, many companies' new hires are individuals who are paid only for direct billing time or who do not receive the fringe benefits current employees receive. Real cost saving are achieved not only by lower costs but also reduction of disguised idle time (often charged to "marketing" or "administration").

5. ***Reclassify certain indirect functions as direct.*** Certain functions like contract and subcontract administration, purchasing, materials inspection, etc. can be identifiable with specific contracts rather than included in an indirect cost pool spread over all contracts. Many of these costs can be charged to other contracts and excluded from overhead.

6. ***Change the G&A base.*** If, for example, government contracts are likely to have a higher subcontract or material component compared to other contracts, you may want to shift from a total cost input base to a value added base (e.g. calculating and applying G&A costs to labor and overhead only).

7. ***Exclude costs.*** This might be desirable if winning a government contract can substantially benefit commercial work or reimbursement at less than cost might help retain highly skilled labor during a lull. Alternatively, you may want to consider a bottom line reduction from the indirect cost pool in the form of a "customer concession". This one time concession would not be considered a precedent on other contracts but care should be taken to make sure other contracts do not absorb these deleted costs.

8. ***Reduce proposed profit/fee.*** Propose lower fees or eliminate fees on certain type of costs (e.g. subcontractors).

9. ***Create a new business unit.*** A separate business unit (e.g. producing only for the government or one product or service) could justify a disproportionate allocation of home office expenses such as marketing, research and development, etc. Also, a new unit could be staffed with personnel having lower direct rates and fringe benefits without impacting other business units.

10. ***Aggressively reduce indirect cost rates.*** Though it can be risky, assume a larger business base (e.g. denominator) to spread indirect costs over. This is particularly effective if cost reduction measures or aggressive pricing is expected to generate more business.

11. ***Find outsourcing opportunities.*** In addition to the cost savings benefits of shifting less critical functions to more efficient subcontractors, a lower subcontract rate could be developed and applied to outsourcing costs. This would shift some indirect costs out of overhead or G&A and still achieve a lower cost than applying the old, higher indirect cost rates to the direct labor replaced by subcontractors.

12. ***Base pricing on aggressive performance improvement estimates.*** Instead of using normal estimates of performance (e.g. history), price the proposal according to aggressive estimates of improvements being planned. You can use these prices as a project budget and, if you wish, develop compensation bonuses that if attained, can be included in fringe benefits.

Some of these measures will create changes to current accounting practices. If your firm is covered by cost accounting standards some form of cost impact analysis on your other contracts may be required. If not CAS covered, there is considerably more leeway in making these changes. Careful planning and communication with government auditors and your CO will likely avoid problems associated with these accounting and pricing actions while helping your organization remain competitive in today's government marketplace.

RESPONDING TO A DCAA DISALLOWANCE OF "PUBLIC RELATIONS" COSTS

(Editor's Note. Advertising and public relations expenses represent likely areas for audit scrutiny. These costs are often significant and since they are considered "expressly unallowable" often include penalty provisions. The regulation covering "public relations" expenses is one of those cost principles that can be subject to many interpretations. FAR 31.205-1 defines public relations costs as functions and activities dedicated to enhancing an organization's image or products and maintaining or promoting favorable relations with the public and intends for such costs to be unallowable. But the same regulation makes certain public relations costs allowable so disputes will arise on whether a given transaction is an unallowable public relations expense or meets one of the many allowable activities. Below is a summary "case study" of a response our consulting group made to a DCAA draft audit report that questioned certain vendor charges as unallowable advertising and public relations expenses. The client is a large engineering firm and we will refer to it as "Contractor.")

Background

The costs being questioned relate to various printed material Contractor produces and makes available to whoever asks for information. Contractor receives numerous requests from a large number of constituents to provide information about its technologies, capabilities, nature of its projects, experience of personnel, analyses of risks, contacts for follow-up technical questions, etc. Rather than respond individually to these requests, Contractor prepares material in advance to provide the requested information. The constituents who regularly request information include actual and potential clients (government and non-government), actual and potential vendors, various community groups, actual and potential teaming partners, security analysts, representatives of the media, etc.

The disputed material includes the following:

1. *Statement of Qualification*. These are spiraled notebook-like items consisting of 10-50 pages printed on two color paper. The cover sheet is full colored and glossy while all the pages inside are either one or two colors printed on plain paper. All contain a description of Scope of Services, Project Profile and Professional Profiles for distinct engineering specialties (e.g. OSHA, environmental services, etc.).

2. *Comprehensive Resources Strategic Solutions*. These are full colored items printed on glossy paper usually including photographs. They are either in the form of a one page foldout with six individuals pages or a small spiraled notebook. For the 6 page foldouts, there is a cover page followed by page(s) containing a list of services (1-5 pages). Some have additional information such as list of offices and information about the company. Like the Statement of

Qualification there is separate material for various industries.

3. *Financial Reports*. These include annual reports for various years.

4. *Environmental Regulatory Agency Atlas*. This is a 192 page, three color 5" by 3" small manual that lists agencies with maps and directions.

5. *Information Sheets*. One or stapled four page information sheets that are primarily two color plain sheets that cover a wide range of information. For example, random selection of five Information Sheets included Environmental Site Assessment, Community Outreach In Oakland, Representative Client List, List of Nevada Offices and Projects and Bioremediation Services

6. *Folders*. These are two page two colored folders printed on glossy paper which are intended to hold the other material.

DCAA Position

During its audit of two years of incurred cost proposals, DCAA examined numerous transactions and isolated the invoices of one vendor that produced the material discussed above. The invoices included design and production of the material and DCAA questioned over $250,000 of the invoices in each year. It referenced FAR 31.205-1 as grounds for disallowing the costs stating the design and production costs associated with the material was "unallowable advertising and public relations costs." Also, since FAR 31.205-1 "expressly disallowed the costs" DCAA recommended imposition of penalties on the questioned costs.

Our Response

♦ Allowability

Though we agree that the referenced FAR 31.205.1 cost principle is the appropriate cost principle, we believe sections FAR 31.205-1(e)(2)(i), (ii), (iii) and (f)(3) are the relevant sections of the cost principle to consider. Specifically:

FAR 205-1(e)(2)(i). "Allowable public relations costs include costs of responding to inquiries on company policies and activities." Rather than respond to large numbers of inquiries with individualized responses, Contractor believes it is prudent to anticipate inquiry areas and have ready responses that can be selected and sent out quickly. All the material in question is material used to respond to inquiries about Contractor's policies and activities.

FAR 205-1(e)(2)(ii). "Allowable public relations costs include costs of communicating with the public, press, stockholders, creditors and customers." The material in question is used frequently to communicate with each constituent identified in the above FAR section, especially customers and creditors (e.g. vendors).

FAR 205-1(e)(2)(iii). "Allowable public relations costs include costs of conducting general liaison with news media and Government public relations officers…" The material in question is also frequently distributed to representatives of various media (e.g. numerous industry publications, various media groups) and government representatives including government public relations officers, project managers, technical and contracting personnel. The material is provided either when requested or when Contractor decides the public needs to be informed about its experience or capabilities.

FAR 205-1(f)(3). "Costs (are unallowable) of sponsoring meetings, symposia, seminars, and other special events when the principal purpose of the event is other than dissemination of technical information." The nature of the material in question can most accurately be characterized as "dissemination of technical information."

♦ Discussion of Material

In our response, we selected a broad range of samples of the materials and discussed in detail the nature of each type of publication. Whereas some of the material clearly related to dissemination of technical information other were not so we, at the least, hoped to demonstrate where a majority of the costs were allowable so there would be considerably less questioned costs. A brief summary of our discussion of the material is presented below.

The item representing the majority of material, *Statement of Qualification*, clearly meets the allowable function of "dissemination of technical information." It is a drab product – plastic spirals, single color printed on simple paper (only the cover sheet is multi-colored and glossy) and is single spaced where the text simply describes Contractor's services, projects and personnel relevant to specific technical areas (e.g. geoanalytics, storage tanks, solid waste, hazardous waste, etc.). There is no way the contents of this item could ever be confused with "splashy" public relations brochures.

Similarly, the *Atlas* and Contractor's *folder* is purely functional. The atlas provides information on the locations of environmental agencies while the company folder is merely a vessel to hold other information distributed to constituents.

Only the *Comprehensive Resources Strategic Solutions* and some of the single sheet *inserts* contains some of the elements that may be associated with brochures like multi-colors, photographs and glossy paper. These items, however, are rarely distributed by themselves but are usually sent with other material where the overall intent of the entire package is consistent with the allowable sections of the FAR 205-1 sections (e.g. communications, liaison, etc.) Most commonly, a package of information consists of most, if not all, the items identified and are almost always sent for at least one of the following purposes – to provide "technical information" to a constituent, liaison with news media or government and most commonly to either respond to inquiries on company activities and policies or communicate with various constituents such as the "public, press, stockholders, creditors and customers."

In response to distinctions DCAA often makes between material printed on glossy paper with multicolor (which are designated as unallowable) versus more plain items we responded as follows. The existence of glossy paper and multi-colors on a few of the items the vendor provides should not be confused with advertising and public relations material. The days when there was a significant price difference between one to three colors printed on nondescript paper and multi-colored, glossy paper where the later was reserved only for "advertising" are gone. Now, there is little price difference between the two types of material so the existence of material printed on glossy paper using multiple colors does not mean the material is for advertising – we maintain that different types of printed material can and is used for allowable communications purposes.

Penalty

Since the cost is unallowable in accordance with FAR 31.205-1 DCAA is recommending that a penalty be imposed equal to 100% of the questioned costs applicable to relevant cost type contracts in accordance with FAR 42.709-1 and FAR 52.242-3, "Penalties for Unallowable Costs." (*Editor's Note. The purpose of responding to the imposition of penalties is not so much to change DCAA's mind as to lessen the contracting officer's interest in seeking penalties. Though its guidance does not necessarily require it to do so, DCAA often takes a rather expansive view of what is expressly unallowable – if a FAR 31.205 cost principle can be cited it is usually considered expressly unallowable and hence subject to penalties. When DCAA does take this position, we usually find them unwilling to budge but we are frequently successful when arguing the point at the contracting officer level.*)

We disagree that the costs are "expressly unallowable." (*For a detailed discussion of Penalties on Unallowable Costs see our GCA DIGEST article in the Fourth Quarter 1999 issue*). "Expressly unallowable cost" is really a narrow term where both the FAR and CAS 405.30(a)(2) define it as "a particular item or type of cost which under the express provisions of an applicable law, regulation or contract is specifically named and stated to be unallowable." In explaining the term, Preamble A to the original promulgation of CAS 405 refers to "costs whose unallowability is obvious" and costs that are "obviously unallowable." In their discussion of an example, entertainment costs, the authors of the Preamble concluded the definition of "expressly unallowable cost" is limited to obvious costs that are explicitly unallowable in *all* circumstances under the FAR 31.205 cost principles.

Court and board decisions have further confirmed this narrow definition and limited "expressly unallowable costs" to those cost principles where the cost is unallowable under "any circumstance". In *Emerson Electric Co.* (ASBCA 30090) the Board defined expressly unallowable cost as a type of expense that a cost principle states is unallowable in its entirety, using the term "clear beyond cavil." Several cases have pointed to specific costs being expressly unallowable because they were unallowable in "all" circumstances (e.g. entertainment, claim prosecution, bad debts, amortization of goodwill, alcoholic beverages). Few other types of costs found in FAR 31 are "obviously unallowable" because some type of costs are allowable while similar costs are not. Just because the cost principles make a cost unallowable does not make it "expressly unallowable." The courts have also ruled that the existence of a reasonable dispute as to a costs allowability means that cost is not expressly unallowable. In *Martin Marietta* (ASBCA 35895) the court ruled a reasonable dispute exists when the contractor's position that the cost is allowable has sufficient validity to create more than a little doubt regarding its allowability.

Here, the questioned costs do not meet the conditions for being expressly unallowable. First, FAR 31.205-

1 does not make every advertising (e.g. help wanted adds, disposition of excess material) and public relations expense unallowable. Since not all costs addressed by this cost principle are unallowable, they do not meet the condition of being unallowable "under any circumstance." Second, the nature of the costs in dispute plausibly correspond to allowable types of public relations costs. As a reasonable dispute certainly exists, the disputed costs do not meet the condition of "clear beyond cavil."

SUBCONTRACTING

(Editor's Note. Subcontracting with the federal government can be quite profitable but the roles, rules and requirements of subcontractors can be uncertain. "Subcontractors" include any suppliers, distributors, vendors or firms that furnish supplies or services to prime contractors or other subcontractors. Sometime the federal procurement rules apply to subcontracts but other times they do not – relatively few subcontractors know the difference. These uncertainties are exaggerated by the fact many subcontracts are awarded in a "hurry up" context, where negotiations between the prime and subcontractor might be conducted by telephone, fax or email under rushed circumstances. Subcontractors are often saddled with uncertain contract terms because they feel they have to "take it or leave it." Given these pressures and the lucrative opportunities that exist both prime contractors and subcontractors need to understand the fundamentals of subcontracting. In this article we intend to clarify several issues related to subcontracts. The following article is based upon an excellent article we found in the February 2003 edition of Briefing Papers written by Steven W. Feldman, an advisor to the U.S. Army Engineering and Support Center. The author provides references, either regulations or case decisions, for virtually every assertion but we will avoid such extensive footnoting.)

Basic Procurement Rules

Relevant Regulations. Whether it be the Federal Acquisition Regulation, agency supplements to the FAR, General Accounting Office regulations, the Contract Disputes Act, most other federal regulations or "common law" (i.e. case law principles) none apply to subcontractors because the federal government and subcontractors generally lack "privity" – a direct contractual relationship. However, in numerous instances that we will discuss the statutes and regulations can apply to federal subcontractors.

Publicizing and Planning Procurements. The FAR provides that the federal government announce most acquisitions exceeding $25,000 at the government-wide point of entry located at www.fedbizopps.gov. Businesses interested in becoming subcontractors for a particular acquisition should contact the agency for a copy of the solicitation and perhaps more importantly, attend the agency's in person proposal conference in order to gain additional insight about the procurement and interact with other firms especially prospective prime contractors and upper-tier subcontractors. Other FAR provisions in the procurement planning process affecting subcontractors under larger acquisitions include (1) agencies must address their plans for achieving subcontract competition (2) establish solicitation mailing lists for interested firms and (3) will have small business specialists to aid small businesses. Of course, proper planning should begin even before the RFP is let. Since effective prime contractors are in communication with the government even before the requirements of a contract are defined, potential subcontractors should be working with prime contractors to help in their efforts in order to become key subcontractors and team members.

Subcontract Competition. Though most federal procurements are subject to the "full and open competition" requirements where all responsible sources must be permitted to compete, these requirements do not apply to subcontracting, which gives prime contractors great leeway on subcontractor competition. The only exception is for cost reimbursement contracts that include the "Competition in Subcontracting" clause at FAR 52.244-5 that requires prime contractors to select subcontractors "on a competitive basis to the maximum practical extent." The contractor is required to determine the availability of subcontractor sources unless the government includes a warranty of the source's availability or directs all prospective prime contractors use a particular subcontractor.

Contractor Team Arrangements. Ordinarily the government will recognize the integrity and validity of contractor team arrangements as long as the arrangements are identified and the company relationships are fully disclosed. The chief exception to this rule is where the combination violates a federal antitrust law.

Subcontract Consent. Sometimes the government must consent to the placement of subcontracts. If a prime contractor has a government approved purchasing system prior government consent will be limited only to subcontract limitations set by the CO in the "Subcontract" clause of the prime contract. If there is no such approval consent to subcontract is required

for cost reimbursement, time and material, labor hour or letter contracts and for un-priced actions under fixed price contracts exceeding the simplified acquisition threshold (currently $100,000). Under cost type contracts, the contractor must notify the agency before award of any cost-plus-fixed-fee subcontract and any fixed-price contract that exceeds the dollar limits specified by regulation. In granting consent the CO must consider several issues. For example, COs may not accept cost type subcontracts exceeding certain minimum allowable fees or an agreement that requires the CO to deal directly with a subcontractor.

Subcontractor Costs and Pricing. The CO determines price reasonableness for all awards including subcontract costs. Prime contractors (and higher-tier subcontractors) must contribute to this process by (1) conducting appropriate cost or price analysis to determine reasonableness of proposed subcontract prices (2) including the results of these analyses in their price proposal and (3) submitting cost or pricing data, when required, as part of its own cost or pricing data. The meaning of "cost or pricing data" has a long history of dispute but it basically means all verifiable factual information as of the date of price agreement which a prudent buyer and seller would expect to affect price negotiations significantly. The author reminds us the FAR has a rather complex set of rules on when cost or pricing data is required or exempted from prime contracts (e.g. commercial items, adequate price competition). Regarding subcontracts, the prime contractor must obtain and analyze cost or pricing data when the higher-level contractor is required to submit the data and (1) the subcontract is $10 million or more or (2) the agreement is more than $550,000 *and* is more than 10% of the higher-level contractor's proposed price, unless the CO considers such data unnecessary. On the other hand, the CO may require submission of cost or pricing data below the above threshold where deemed necessary for reasonable pricing.

Patent and Data Rights. The FAR has extensive rules governing rights in patents and data in contractor deliverables. These FAR prescriptions are implemented through more than 20 possible contract clauses plus additional ones in individual agency supplements. The author recommends contacting a legal specialist in these areas but offer a few general observations. FAR Part 27.3 addresses contractor patent rights and the general rule is the policies and procedures covered here apply to all contracts at any tier. FAR Part 27.4 covers data rights and the government's policy is to strike a fair balance between the agency's mission needs and the contractor's legitimate proprietary interests. Since rights in data – such as computer software documentation – frequently concerns subcontractor products the authors urge subcontractors to achieve a full understanding beforehand with their prime contractors about the rights in deliverables provided to the government. As for data right rules in DOD contracts, the applicability of data rights to subcontractors is still "unsettled". DFARS Part 227.71 states data rights are to apply equally to prime contractor and subcontractors which implies that DOD clauses are included in subcontracts as a matter of law; however case law indicates that subcontractor's rights in technical data are controlled by its contract with the prime, not the prime contract with the government.

Taxes. The FAR provides that prime contractors and subcontractors are generally not considered agents of the government for purpose of claiming the government's immunity from sate and local taxation. Only an exemption under state or local law – if one exists at all – will provide tax relief for a transaction where the subcontractor provides supplies or services to a higher tier contractor. FAR 29.305 prescribes the rules whereby subcontractors may obtain state and local tax exemptions.

Commercial Item Subcontracting. The FAR expresses a strong preference for prime contractors and higher-tier subcontractors to incorporate "commercial items" or "non-developmental items" as components of items delivered to the government. The prime or upper-tier contractor has the discretion to make this determination and is not required to include any particular FAR clause in its lower level agreement except those required by regulation which is addressed in the "Subcontracts for Commercial Items and Commercial Components" clause at FAR 52.244-6.

Flow-Down Clauses

To maintain control over government agencies and ensure consistency in federal procurements FAR Part 52 contains numerous mandatory clauses to be included in prime government contracts under stated criteria. (*Editor's Note. We refer the interested reader to our Fourth Quarter 2002 issue of the GCA DIGEST (Vol. 5, No. 4) where we provide a list of mandatory and recommended FAR clause flow-downs that are identified by the Committee on Federal Subcontracting Section of the Public Law group of the American Bar Association. You can call them at 1-800-285-2221 to obtain a copy of their publication for $45.)*

Where the FAR authorizes COs to include the clause in the prime contract by reference i.e. FAR citation, title and date as opposed to the entire text, prime contractors must flow down the substance of FAR clauses and not just incorporate them by reference.

The author stresses the need to carefully review the clauses flowed down by the prime or higher-tier subcontract since there is the tendency for subcontracts to indiscriminately include excess FAR clauses including those intended only for a prime contractor. Typically, a prime contractor may use a commercially available standard subcontract that includes fill-ins and preprinted terms (e.g. contract payments, changes, terminations) and then will incorporate wholesale all the FAR prime contract clauses in the subcontract with little consideration for whether it should be flowed down. The results frequently are (1) the FAR clauses duplicate or often conflict with the preprinted commercial terms (2) the clauses have no substantive application to the subcontract because they are prime-contractor unique and (3) inclusion of the referenced FAR clauses likely fails to reflect the intentions between the parties. Another common example is under a cost plus fixed fee prime contract where firm-fixed price subcontracts are issued, the prime contractor often flows down its cost type clauses resulting in considerable confusion. Problems are not fixed when the prime contractor simply introduces the clauses by stating the word "prime contractor" will substitute for "government" or similar expressions. Subcontractors are encouraged to ensure their agreements do not include all prime contract FAR clauses and also when FAR-prescribed flow-down clauses are incorporated other conflicting terms should be eliminated.

Prime Contractor Source Selections and Subcontracts

Most acquisitions over $100,000 are government negotiated contracts governed by FAR Part 15 where price and non-price factors are considered, discussions are allowed and revisions to proposals are common once proposal deficiencies are pointed out. Under negotiated proposals, subcontractor information and eligibility are key items.

Subcontractor Participation. Some regulations or contract terms may limit the offeror's ability to use subcontractors in small business set aside prime contracts. The "Limitations on Subcontracting" clause (FAR 52.219-14) restricts the amount of subcontracting in service contracts where the prime must use at least 50% of the cost of contract performance incurred for personnel for its own employees. Construction contracts will commonly prescribe certain percentages of the work done. Several clauses strongly encourage prime government contractors to subcontract with small business concerns and disadvantaged small businesses and FAR 52.219-10 requires that each successful offeror on a contract exceeding $500,000 ($1 million for construction) submit an acceptable subcontracting plan where monetary incentives for outstanding performance (FAR 52.219-10) and penalties for lack of good faith performance (FAR 52-219-6) are included. Subcontracting is important in research and development contracting where in FAR 35 the government emphasizes agencies need to know whether proposed subcontractors are qualified and hence need to have advanced knowledge of subcontracts for technical or scientific work.

Organization Conflict of Interest. Sometimes organizational conflict of interest (COI), which exists when because of other activities or relationships an organization is unable or potentially unable to render impartial assistance to the government, can create grounds for protests. The GAO has held an awardee will have an unfair competitive advantage when the proposed subcontractor possessed competition-available information through its prior government work which is not available to other offerors.

Subcontractor Experience. When the solicitation has no restrictions on subcontracting there is significant room to use subcontractors to enhance proposals because the government may accept a proposal with substantial subcontracting and no offeror may be penalized merely for proposing subcontractors. Agencies may reasonably consider a proposed subcontractor's experience when rating prime contractor qualification if the solicitation allows subcontractors to perform the particular work *and* if the RFP does not prohibit such evaluations. Also, no prohibition exists against more than one offeror proposing the same contractor.

Subcontractor Past Performance. When evaluating an offeror's past performance the agency may grade the offeror based on the performance of its proposed subcontractors on previous projects because the prime contractor is responsible for its subcontractors' performance. Government evaluators may reasonably decide not to credit the offeror with its subcontractor's performance when the subcontractor would do minimal work under the contract.

Mistakes in Subcontract Offers. The general principle is that awards can be adjusted for mistakes when they are clear-cut clerical or mathematical errors or misreading of specifications as opposed to judgmental errors. When the prime contractor's error is based on the subcontractor's error the prime contract is still adjustable as long as the prime contractor was unaware of the underlying error.

Subcontractor Responsibility. COs are prohibited from awarding contracts to "nonresponsible" contractors (e.g. deficient in financial resources, ability to meet contract requirements, satisfactory performance record, integrity and ethics) so contractors need to affirmatively demonstrate its responsibility including that of its subcontractors. Agencies may assume the prime properly ascertained its subcontractor's responsibility unless evidence shows the prime made an insufficient investigation. The government is entitled to make its own independent determination of a subcontractor's responsibility.

Debarment and Suspension. Agencies may debar or suspend subcontractors form participating in government contracts when they are debarred or suspended. The government uses the List of Parties Excluded From Federal Procurement and Non-procurement Programs available at http://epls.arnet.gov.

Subcontractors' Right of Protest. In general, since subcontractor arrangements are essentially private matters between prime contractors and subcontractors, aggrieved subcontractors have few rights in a federal forum to challenge alleged violations of procurement rules before award of the contract. The General Accounting Office is the usual forum for "protests" - a written objection by an interested party to a solicitation or award where the objection alleges improprieties in the award of a contract. Since an "interested party" is defined as an "actual or prospective bidder or offeror whose direct economic interest would be affected by the award" a subcontractor would not meet this definition. This interested party exclusion also applies to protest efforts at either the U.S. Court of Federal Claims and at the agency level since the definition of interest party is the same.

The GAO does recognize an exception for subcontractor protests where the subcontract selection is "by" the government. This process occurs when all or most meaningful aspects of the procurement are controlled by the federal agency officials and the prime contractor is a mere conduit of the agency whose primary concern is administrative. Also, subcontractors may be entitled to monetary relief when their prime contractors prevail in a joint effort protest to the GAO where successful protesters may recover costs for bid and proposal preparation costs and protest costs.

Contract Administration Issues

Miller Act Payment Bonds. Contracts covered by the Miller Act require payment bonds from the prime contractor on projects exceeding $100,000. The Act is intended as a substitute for a subcontractor's right to obtain a mechanics lien under state law because federal property is immune and the Miller Act is quite effective in ensuring payments to subcontractors. The payment bond protects subcontractors by ensuring payments to all persons supplying labor or material for the contract. Payment bond coverage is limited to the first and second tier subcontractors so no coverage exists for subcontractors of suppliers or third or lower tier subcontractors.

Subcontractor Payment. Subcontractors' ability to obtain assistance from the government in collecting payments from the prime contractor is pretty limited. As to how COs should deal with subcontractor complaints of untimely payments Congress enacted a statute (National Defense Authorization Act for 1992 and 1993) requiring COs to take certain actions upon receiving complaints of subcontractor nonpayment for all type of contracts. Implementing the statute in FAR 32.112, if the CO finds the prime contractor is not in with compliance with subcontractor payment terms the CO may (1) encourage the contractor to make timely payments or (2) reduce or suspend progress payments to the prime as authorized by the applicable payments clause. Subcontractors should not expect extensive CO mediation or resolution of the controversy since lacking privity with the subcontractor, the government usually does not wish to expend the time and resources to investigate all the facts and instead, expects the prime and subcontractor to resolve their own disputes. Most COs, however, will be concerned about whether the prime contractor's certification of payment of a subcontractor or supplier accompanying its payment request is accurate. As an additional aid to subcontractors, FAR 32.112 provides that upon request of a subcontractor or supplier, the CO must promptly advise the inquirer as to certain information such as whether the prime contractor has submitted requests for progress payments to the government or whether it has received final payment. Subcontractors

on construction contracts have greater leverage. Congress amended the Prompt payment Act in 1988 to help ensure timely subcontractor payments on construction contracts by adding the "Prompt Payment for Construction Contracts" clause at FAR 52.232-27 that requires subcontractor payments for satisfactory performance within seven days out of payments received from the government with an interest penalty for late payments. This clause has flow-down coverage for each lower-tier subcontractor.

Government Contract Quality Assurance. The various QA functions such as inspection provided in the contract will generally not be performed for subcontracts except in limited circumstances. For example, the government must perform the QA function at the subcontract level when the item is to be shipped from the subcontractor's facility to the using activity and the inspection at the source is required. It should be noted that such government review does not relieve the prime contractor of its contract responsibilities.

Use of Government Supply Sources. Addressed in FAR 51 the government may permit the subcontractor to use government supply sources (e.g. GSA Federal Supply Schedules) under cost type contracts or other subcontracts where the majority of the supplier's subcontracts are cost type.

Effect of Subcontractor Default. Under the standard "default" clauses the prime contractor is accountable for excess costs of re-procurement based on a default stemming from delays in providing goods or services even when such default is caused by the subcontractor. An exception is allowed when the failure to perform based on the subcontractor's default is beyond the control of the prime or subcontractor and neither is at fault or negligent. Cases have held that illness or death of subcontractor personnel is not excusable because contractors must provide acceptable workforces but prime contractors can be excused for subcontractor delays due to production difficulties beyond the existing state of the art and that were outside the contemplation of the principle parties at award.

Pricing of Contract Adjustments. When the government and prime contractor negotiate a pricing adjustment action the prime ordinarily will make the adjustment to its price when the change affects its subcontractor where the adjustment made below the prime contract level is governed by the subcontractor clause addressing changes. Conversely, the prime contractor and subcontractor can be affected when the government and prime contractor negotiate a downward price adjustment from say, deleted government work, but difficulties arise when the subcontract does not include the subcontract clause. Board cases have held that where the prime contract change reduces subcontract costs the prime contractor can be liable to the government even though it is unable to obtain a price reduction from its subcontractor so the prime must protect itself by inserting appropriate coverage in the subcontract.

Impact of Terminations. When the government terminates a prime contact the prime makes a corresponding subcontract termination and the provisions of FAR 49 spell out the procedures for settling both the prime contracts and subcontracts. The overriding principle is the subcontractor has no contractual rights against the government upon termination of the prime contract and the prime contractors and subcontractors are responsible for the prompt settlement of their termination settlement proposals.

Subcontractor Claims and Disputes With the Government. Under the Contract Disputes Act a "contractor" has the right to have a claim against the government be considered by the contracting officer and appeals heard by agency boards of appeal or the U.S. Court of Federal Claims. It is quite common for a subcontractor to believe it has sustained damages by government action but since the CDA and the FAR "Disputes" clause (FAR 52.233-1) use the term "contractor," subcontractors generally do not have a right to seek and collect damages because they are not in privity with the government. Accordingly, where the subcontractor seeks relief from the government it can proceed indirectly through the prime contractor in one of two ways: first, the prime contractor must sponsor and certify the subcontractor's claim where the certification reflects the prime contractor's belief there is "good ground" for the claim and second, a prime contractor filing a claim can include a component for its liability to a subcontractor. It should be noted that in an old 1943 case of *Severin v. United States* the government held the prime contractor is not entitled to collect for the subcontractor when it has no liability for the subcontractor's costs. Later cases put the burden on the government to prove there was no liability.

There are rare exceptions to the general "no-direct right of action" rule for subcontractors in CDA cases. First, the subcontractor will have a direct right of action where the contract terms state that parties intended to give the subcontractor the right to direct

appeal but since the FAR prohibits the COs from consenting to such an arrangement this circumstance is practically non-existent. Second, privity for CDA purposes will exist where the contract provides that the contractor will act as a purchasing agent for the government. Third, subcontract privity will be present when the government so circumvents the authority of the contractor that the contractor becomes a mere agent of the government. For example when the Small Business Administration awards an agency a contract under the "8(a) program", the agency subcontracts with an 8(a) firm and that firm may take direct action against the government.

The author provides a practical summary checklist:

1. Subcontractors generally do not have a direct contractual relationship – privity – with the federal government and hence have few contractual rights and responsibilities to each other.

2. The FedBizOpps has valuable information for prospective subcontractors seeking business opportunities with prime contractors. Prospective subcontractors should also be familiar with other avenues of potential business such as pre-proposal conferences for the prime contractors and a particular agency's website.

3. Guard against inappropriate flow-down clauses from the prime contract especially where they conflict with other subcontract clauses. Also make sure that applicable key clauses such as those addressing data rights, pricing of adjustments and rights upon government terminations are included in the subcontract.

4. Since prime contract awards commonly depend on the quality of proposed subcontractor's technical qualifications and past performance work closely with your prime contractor to ensure these are in order.

5. Prime contractors need to ensure their proposed subcontractors are not debarred or suspended.

6. Subcontractors generally have no right of protest but one narrow exception is the subcontractor can recover subcontract proposal preparation costs where the prime contractor prevails in a protest.

7. Subcontractors have only limited rights to obtain the assistance of government COs when prime contractors do not pay on time. However, the Miller Act under construction projects gives subcontractors extra protection when a payment bond is available.

8. Subcontractors having a dispute with the government generally have no rights of direct appeal so if they believe the government action warrants a remedy they should attempt to persuade their prime contractor to either "sponsor" a claim or include your costs in the prime contractor's claim. Also, investigate whether one of the rare circumstances for privity exists.

9. Familiarize yourself with FAR Part 49 if your subcontract is terminated to maximize your recovery.

Knowing Your Cost Principles...
CONTINGENCY TYPE COSTS

(Editor's Note. Where it is often prudent to include a "contingency factor" when pricing commercial contracts, the pricing of government contracts significantly limits such practices, particularly when cost estimates are used. As part of our continuing series of examining different types of costs, we thought it would be useful to discuss the allowability and allocability of "contingency type" costs. Our sources includes several texts including Mathew Benders "Accounting for Government Contracts" as well as our experience as former DCAA auditors and our current role as consultants.)

General Comments

Contingent costs are initially unrealized costs. They are costs that may or may not actually be incurred in the future. Examples of contingent expenses are service costs, warranty costs, insurance, indemnification and bonding costs as well as potential lawsuit liabilities. FAR 31.205-7 addresses "contingencies" as a generic cost and defines it as a possible future event or condition arising from presently known or unknown causes, the outcome of which is presently indeterminable.

Allowability. FAR 31.205-7(b) provides that contingency costs are generally unallowable for historical costing purposes because such costs deal with costs incurred and recorded in contractors' books of account. It does provide for exceptions to this rule citing terminations costs as an example. Inclusion of contingency costs in claims and even incurred costs submittals as well as termination settlement proposals may be appropriate if they involve "minor unsettled factors in the interest of expediting settlement."

Certain contingency costs are generally allowable for purposes of making cost estimates for either cost type or fixed price work. The FAR follows generally accepted accounting practices in distinguishing

between two categories of contingency costs. The first category consists of contingencies that arise from presently known and existing conditions whose effects are reasonably foreseeable. Common examples of such costs are anticipated costs of rejects or defective work where costs of salvage and rework can be included in cost estimates. The Board of Contract Appeals has overturned challenges to use of a factor for warranty costs on the grounds they could be known based on exiting conditions (ASBCA No 12538). Historical data are usually relied on – so, for example, rejects occurring on similar contracts or provision of similar goods and services can be known and used as a basis for estimating the costs of rejects on the current contract.

The second category consists of contingencies that arise from conditions either known or unknown but whose effect cannot be sufficiently measured to provide equitable results to either the contractor or the government. Most lawsuits are considered examples of this second category where they are excluded from routine cost estimates. If inclusion of the contingency costs are included in cost estimates, the burden falls on the contractor to demonstrate they are of the first category. Also, though the second category of costs are excluded from routine cost estimates they may be separately estimated to negotiate an appropriate contractual coverage of costs (e.g. contract re-opener clause) though such action is usually a tough sell.

Service and Warranty Costs

Service costs arise from contractual obligations to provide, for example, installation and training. When not considered inconsistent with contract terms, these costs are allowable. Warranty costs resulting from contractual provisions to correct product defects, replace defective parts and make refunds in the event of inadequate performance is allowable. You should expect to receive audit scrutiny to provide assurance that "double counting" is not occurring where there is a duplication of recovery first as a cost of production and then as a separate cost. For example, production cost estimates should exclude service costs from the production cost history when the proposal estimates separate service costs.

Service and warranty costs can be a direct contract charge, indirect period cost or an indirect cost allocated on a reserve basis. As a direct charge, the cost must be included in the contract cost estimate as another direct cost and then allocated specifically to that contract. As an indirect period cost, the costs of all warranties are estimated for the period and included in the appropriate indirect cost pool. As actual costs are incurred, the costs are associated with the same cost pool. As an indirect cost allocated on a reserve basis, the estimated annual costs are either charged directly to cost objectives or to an indirect cost pool with a corresponding credit to a reserve for warranties. When actual costs are incurred, the charge is made to the reserve account.

When evaluating proposals, auditors can be expected to verify that a warranty was either requested by the contract solicitation or required by regulation. Auditors commonly check for inconsistencies between government and commercial product warranties, examine historical warranty cost data, try to identify trends that might have an impact on future warranty costs and review historical costs to assure that product and warranty costs have been segregated. To assure there is an equitable allocation auditors also review warranty costs by product line to determine the relationship between the costs and the government purchases.

In 1983 Congress passed legislation to require extensive use of warranties in purchasing weapon systems. Before 1983 warranty provisions were generally limited to other than cost type contracts and DOD still holds this position. Because of the problems in estimating and negotiating warranty costs many fixed price contracts still do not contain warranties, reasoning that the cost is too great to be justified by the benefit.

Insurance and Indemnification

Though we have addressed insurance costs in considerable depth in a previous issue we thought we would provide some summary information in this section since insurance costs are considered an important subset of contingency costs. Allowability criteria is as follows:

1. Self insurance plans need to meet the requirements of CAS 416 as well as the administrative requirements established by FAR 28. The self insurance costs plus administrative expenses of the program cannot exceed the cost of purchased insurance when it is available. Self insurance for catastrophic losses is not allowable.

2. Costs of insurance related to the general conduct of business is allowable with certain exceptions. The type of coverage must follow sound business practices

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common in the industry and the cost must be "reasonable."

3. Business interruption insurance premiums are allowable except for any portion that provides for coverage for loss of profits.

4. Life insurance on company officers is considered additional compensation when the policy names another officer as a beneficiary. If the company is the beneficiary, the costs are unallowable.

5. If insurance coverage exists for a particular occurrence the contractor must seek recovery on the insurance rather than indemnification from the government.

6. We have often seen the government attempt to challenge the cost of professional liability insurance by arguing the government work does not subject a company to liability suits or the government indemnifies contractors for legitimate claims. In other circumstances, the government may not challenge the allowability of the costs but will challenge the allocability of the costs to government contracts. Though auditors are required to compare the commercial and government work to ensure the relative risk is similar, we believe questioned costs based on either allowability or allocability should usually be challenged.

7. Since insurance premiums are reimbursed by the government, actual losses are generally not allowable unless they are (a) expressly provided for in the contract (b) nominal deductibles not covered by purchased insurance policies or (c) minor loses that occur in the ordinary course of business and are not normally covered by insurance (e.g. spoilage, breakage).

8. The costs of insurance protecting against contractor defects are unallowable except for casualty losses (e.g. fires, floods). The rationale is the government does not want to pay to insure against the contractor's own poor performance – it expects to obtain a qualify product or service for the price paid.

Bonding Costs

Bonding costs occur when the government requires assurance against financial loss to itself or to others due to an act of default by a contractor. In addition, a contractor may require similar assurances from subcontractors. These bonds which include bid performance, payment, advanced payment, infringement and fidelity bonds are generally allowable if required by the contract or if required by the general conduct of the business.

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