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LIVING WITH THE GOVERNMENT SHUTDOWN

(Editor's Note. As of this writing the government is shutdown with no resolution in sight. We have written this article to be relevant even if there is a resolution of the shutdown. Many law and consulting firms have put forth guidelines where we have selected a few articles from the law firm of McKenna, Long & Aldridge because they are typical of the guidelines and coincide with our views.)

A Little Information about the Shutdown

A Continuing Resolution was supposed to be put forward by Sept. 30 but now political wrangling over Obamacare derailed the appropriations process and created a funding gap as of Oct. 1. Absent appropriations to fund their operations, federal agencies simply may cease to operate. As of this writing, it seems as if Congress will not be able to agree on federal funding where the consequences for government contractors are significant.

First, in accordance with OMB Circular No. A-11 agencies may not incur any obligations unless authorized by law. They may incur obligations "as necessary for the orderly termination" functions but no disbursements may be made. During an absence of appropriations, agency heads must limit obligations to those needed to maintain the minimum level of essential activities needed to protect life and property.

Second, the effect of the shutdown creates massive furloughs of government employees. Generally only those performing emergency work involving the safety of people or protection of property, involved in suspending agency operations or members of Congress are exempt from furloughs. Federal employees who supervise and support contract performance (such as ACOs, COs and COTRs) are not excepted from furlough and ongoing operational and administrative activities related to contract administration such as oversight, inspection, accounting and payments cannot continue where there is a lapse of funding. A recent memo as of this writing from the Sec. of Defense indicates DOD civilian employees will be back to work.

Third, a lapse of appropriations generally means there are no additional funds made available for contracts – either award of new contracts or the obligation of funds to existing contractors. While contractors can continue performing existing contracts within the limits of obligated funding, performance may very likely be delayed or disrupted by lack of government personnel for administering them or shuttering non-essential government facilities.

Guidelines

The shutdown is creating headaches where the authors recommend taking action now to help weather the storm and survive the shutdown:

1. Determine the nature of contract work. Has the agency identified your contract as being excepted from the shutdown because it provides essential activity needed to protect life and property? Document any shutdown exceptions and clarify which government personnel will be available to administer the contract.

2. Assess cash flow. Definitely plan for a disruption of cash flow where payments delays are expected under the shutdown and their earlier sequestration. Consider which vendor payments can be delayed, obtain or access lines of credit and find other funding sources (e.g. A/R factoring).

3. Assess impact of government furloughs. Determine if a stop work order is issued. A government shutdown may be considered a "sovereign act" precluding any contractual recovery so a stop work order or other contract direction should mitigate this risk so document any such actions in the contract file.

4. Review contract type and funding status. Determine if contracts are fixed price or cost reimbursable and incrementally funded or fully funded. Costs reasonably incurred during a government shutdown should

be recovered through various vehicles (e.g. stop work order, government delay of work, changes clauses) if the contract is funded because the existence of funding established that the government has an obligation it must honor. For incrementally funded, cost type contracts, contractors are supposed to track costs (including potential termination and delay costs) and notify the government when they will exceed 75% of total funding so they should closely monitor costs because once they exceed available funding contractors risk nonrecovery of these costs.

5. Prepare for claims. Document all adverse impacts on performance (e.g. written narratives, project logs, daily reports). Establish separate job numbers to capture increased costs due from the shutdown. Notify the CO of any performance issues caused by the shutdown (even if the CO is furloughed) and advise subcontractors to document the impact on them of the shutdown. Though contractors may be entitled to recover costs and revise schedules they are responsible for taking reasonable actions to reduce the costs caused by the shutdown such as considering work-arounds, diverting employees to commercial efforts and potentially furloughing them. If a contractor fails to take mitigation steps, the government may attempt to reduce the costs or period of schedule extension so documentation of mitigation steps should be maintained.

6. Consider legal options to cut payroll. We are finding that many companies are paying employees as usual unless the shutdown continues for several weeks. Some are putting exempt employees from the Fair Labor Standards Act (FSLA) on full week furlough and requiring them to use accrued leave. In some situations, some are converting exempt employees to non-exempt hourly employees. The authors warn that furloughing an exempt employee may result in them loosing their exempt status requiring the contractor to pay them overtime wages. They recommend the following options for reducing exempt employee costs: (a) furlough them in weekly increments to avoid FSLA requirements to pay a full week if an employee performs any work (b) use mandatory leave banked or paid time off deductions (c) reduce exempt employees' hours and salary where a recent case (*Walmart Stores Inc., 395 F.3d 1177*) ruled an employer may reduce exempt employees' hours and pay for a fixed period of at least two months or (d) voluntarily reduce hours but make sure the employee's decision is entirely voluntary. Also if mass layoffs or hour reductions are contemplated, be aware that the Federal WARN Act affects employers with over 100 employees (e.g. 60 day notification under certain circumstances) where state laws may be even more onerous.

7. Options are at risk. As we discuss in our options article below, they must be exercised in strict accordance with contract terms. An option can be exercised only if money is available to fund performance so the shutdown most likely means the government will not be able to exercise options and instead will be forced to allow contracts to expire. In this case, acquiring their supplies and services later through new procurements might involve competition and submission of updated cost or pricing data

PRICING CONTRACT MODIFICATIONS
Part 2

(*Editor's Note. There are more reasons than ever for contractors to become capable of identifying and quantifying contract modifications or in everyday terms, changes to existing contracts. Severe budget constraints and shutdowns, efforts to obtain more for less or need for new arrangements such as consolidating work for some and deleting work for others create a variety of change scenarios that contractors need to be able to identify and quantify to maximize its profitability. We have addressed this issue in the past but more acceptable techniques are now available. Our two part article provides some detailed useful information when it comes to preparing a request for equitable adjustment (REA) or a subsequent claim rather than a mere overview of this important topic. In the last issue we addressed direct labor costs (both hours and rates), direct material and subcontract costs and intracompany transfers where in this second part we address common other direct costs, indirect costs (e.g. unabsorbed overhead), estimating future costs and profit. Like Part 1, we are using Darrell Oyer's text on Cost Based Pricing, revisions to Mathew Bender's Accounting for Government Contracts, Federal Acquisition Regulation and our own experiences helping clients prepare and negotiate requests for equitable price adjustments.*)

Other Direct Costs

♦ Travel

Normal per diem rates maintained by the GSA or DOD would apply to lodging, food and incidentals. Airfare could be either full fare costs or if a trip is planned well in advance a 20% discount might be assumed for dis-

count flights. Larger companies or company travel agents may have data to compute a decrement to apply to full fare coach prices.

♦ Equipment Costs Under Construction and Supply Contracts.

Equipment costs. The preferred methods of establishing allowable ownership and operating costs of equipment is to use actual cost data obtained from the accounting records. When actual data is not available the contracting agency may specify use of a schedule of predetermined rates, which may vary by agency, for ownership and operating costs. Allowance for ownership costs include costs of depreciation, taxes and insurance along with a facilities cost of capital while allowance for operating costs may include fuel, filters, oil, grease, servicing, repairs, maintenance and tire wear and repair. Depreciation costs normally charged indirect may be charged direct to the modification if the contractor can show it is reasonable and allocable to the contract. Depreciation or rental costs on fully depreciated equipment is not normally allowable unless there is an agreement between the parties to allow it. The costs of labor, mobilization, demobilization, overhead and profit are normally not included in these rates so they should be claimed separately. To avoid the perception of double charging, the contractor should eliminate all the costs that are included in indirect cost rates. The Courts have ruled that use of predetermined rates are a valid method when actual cost records are not available though Mr. Oyer states it is unwise to place too much reliance on these cases where the government much prefers actual costs.

Idle equipment and loss of efficiency. During a period of government caused delay the contractor should claim costs of idle equipment. FAR 31.205 provides the costs for equipment sitting idle rather than being used but not incurred any wear and tear should be reflected in these claims. The accepted technique is to charge 50% of the equipment ownership expense rate. A contractor is entitled to recover its equipment costs for the period it was either idle as a result of the government caused delay or the equipment was not available for other project use. The Courts have established the contractor must show (1) the equipment was reasonably and necessarily set aside and awaiting use of performance and (2) that is was deprived of its productive use because of the government circumstances and not because the contractor had no other use for its time. A subsequent court ruled that the contractor was entitled to actual costs of renting equipment on another job in which it could not use the idle equipment. A contractor may also be entitled to loss of efficiency on renting other equipment caused by a delay or an acceleration of performance as well as loss of efficiency of the operator.

The costs of idle facilities and idle capacity. *Idle facilities* – excess to the needs of the contract – are not allowable but circumstances where such costs are allowable are when (1) it is necessary to meet normal fluctuations in workload or (2) no longer necessary and are now idle because of changes in requirements, production, economics, reorganization, terminations or other causes which could not have been reasonably foreseen. These costs are allowable for a "reasonable period" which is normally one year but can be longer if it is considered to be an "ordinary" period. *Idle capacity* refers to the unused capacity of partially used facilities. Such costs are considered to be a normal cost of doing business and hence allowable provided it was originally necessary. *(Editor's Note. We have frequently been successful in applying the idle capacity theory to non-equipment such as idle labor costs in both supply and service contracts.)*

The costs of special tooling and special test equipment is normally direct equipment of specific contracts for which it was purchased. Where an item fails to qualify as one of these two because with a relatively minor expense can be adapted for general purposes, those adapting costs are allowable.

Estimating Techniques

General Comments. Unlike incurred costs where actual costs are reviewed, forward looking costs are based on estimates. Direct costs should be presented on a time phased basis and then indirect costs for those accounting periods are applied. Estimates should be based on forecasts – though historical information may be useful for supporting forecasts the primary basis is forecast for relevant periods. Also year to date rates are never appropriate to use – only entire year dates should be used. Though the term "audited" indirect rates may be ballyed around, audits refer to incurred costs while estimated rates are never audited but rather are evaluated. Escalation factors, by tradition not regulation, is usually limited to 3 percent. Finally, one can realistically conclude an increase in indirect rates would likely occur due to (1) idle and standby time (2) storage costs

will likely increase (3) personnel issues will require more recruiting effort and (4) overtime premiums are likely to increase due to uncertain changes and accelerations.

Unabsorbed Overhead

Unabsorbed overhead is a term used to identify the fixed indirect costs that would have been allocated to a delayed contract base costs which should have been incurred had there been no delay. Fixed indirect costs as well as G&A costs that continue to run during a period of shutdown or idle facilities are referred to as unabsorbed overhead. Whereas direct and indirect costs that are variable (i.e. vary with production or service level) can be avoided during a delay period fixed costs cannot be avoided and recovery of these costs must be made. Even some direct costs may be fixed.

♦ Eichleay Method.

Board and court decisions have used several methods to determine the amount of unabsorbed indirect costs allocable to a modified contract. While the Eichleay method is by far the most accepted method for computing the amount of unabsorbed overhead due, several others have been accepted under certain circumstances. The normal fixed overhead allocable to a contract is identified and expressed as a daily rate. The daily rate is multiplied by the number of days of delay to arrive at the total amount of unabsorbed overhead. It is important to first remove all variable costs and identify total fixed overhead costs. The amount of fixed overhead that is attributed to the delayed contract is based on the dollar value of that contract compared to the dollar value of all contracts. That percentage is applied to the total amount of fixed costs, divided by the number of delayed days to arrive at the daily rate.

Though too detailed to recount here the reader should be aware there are at least 8 other methods that may apply under certain very limited circumstances such as the Allegheny, Carteret, Burden Fluctuation, Hudson, Simulation, Enstrom, Manshul and Emden methods.

In addition to the amount of unabsorbed overhead that can be recovered there is an additional amount of extended overhead that may be recoverable. DCAA recognizes that the two amounts may be different, where the later applies to contract changes that extend the period of performance. Overhead applied to direct costs for this extended period is computed by applying the contractor's normal method of computing and applying indirect costs.

Profit

Profit is considered to be an award for proper contract performance. (*The FAR uses the term profit to apply to fixed price contracts and fee for cost reimbursable contracts but here we will refer only to profit to cover all types of contracts.*) Under modification, profit may be the same as under the contract or may be more or less where there are statutory limitations on the amount of profit allowed.

Mr. Oyer states that profit on government contracts are driven by costs whereas on commercial contracts profit is driven by price. As a result, commercial contracts are usually more profitable meaning not that commercial contracts are overcharging their customers but rather government work generally does not provide a reasonable profit. Because of this many businesses choose not to do work with the government while others decide there is ample benefit in spite of the lower profit guidelines.

The underlying principle is that a contracting party that is affected by a change or modification of its contract should be placed in the same economic position in which it would have been in had no change occurred. The measure of damages should not be the value received by the government but rather the altered position the contract is placed because of the change. This theory is known as leave them where you find them – leave them in the same position cost-wise and profit-wise as they would have occupied without a change. In pricing the additional work the contractor is generally allowed the reasonable cost for the work plus a "reasonable and customary allowance for profit." Without this the government would be getting something for nothing and the contractor would not be whole. Thus even if the contract was bid at no profit the contractor is entitled to profit on the additional work.

The courts have ruled profit on the original work that is unaffected by the change should remain untouched. An REA should not be used to reprice a contract which is threatened under a loss – a profit on additional work will be made whether or not a contractor is experiencing a loss on its original contract. Nor should it be used to take away an extra high profit. However, a contractor may be entitled to additional profit on the unchanged

contract work if it can show the changed work increased the overall risk on the entire contract.

The amount of profit on the additional work is tied to the nature of risks involved. Generally, where changes cause minor alterations the same profit rate is applied. However if major changes are involved, different profit rates may apply where higher for higher risk and lower profit if added work is less difficult than originally called for.

Be aware that some federal and state agencies may have their own guidelines on profit. For example, the Federal Highway Administration and National Parks Service as well as many state and local agencies have limited contract modifications to "profit and overhead to an amount not to exceed 15%" when a fixed price could not be negotiated before work began.

BASICS OF EXERCISING OPTIONS

(*Editor's Note. Competition in the government marketplace is intensifying where acquisition officials are now required to be more efficient with procurement funds. We are finding the exercise of contract options to be particularly popular these days. As the exercise of options increase we are seeing significantly more disputes between contractors and their government customers. Accordingly, we see the need for greater clarification of the rights and obligations of the two parties. We were fortunate to come across an article in the July 2013 issue of the Briefing Papers by Stuart Nibley and Sheila Armstrong of K&L Gates, LLP that address the FAR and case requirements, what constitutes improper exercise of options and what can be done.*)

The exercising of options is not unique to government contracts – they are quite prevalent in the commercial marketplace – but the sheer volume of goods and services the government buys makes them particularly important in the federal marketplace. The option vehicle is particularly attractive to the government because they lessen the need to undergo the burdensome acquisition and lengthy competition process required by the Competition in Contracting Act. The exercise of options not only is desirable for the government but also provides significant revenue opportunities for contractors, particularly in an era of budget cutting, where normal costs of bidding on contract work can be significantly reduced.

The revenue opportunities however are often accompanied by considerable constraints because the contractor typically agrees one or more years before option performance to perform at set prices, quantities and/or delivery schedules. Numerous cases have created specific rules for options where (1) the terms for the exercise of options must be specifically spelled out in the contract and (2) their exercise must be made in strict accordance with the contract terms.

What is an Option

An option is a "unilateral right in a contract by which, for a specified time, the government may elect to purchase additional supplies or services called for by the contract or may elect to extend the term of the contract." Inclusion of an option does not require the government to exercise the option but rather gives it the right, at its sole discretion, to purchase additional products and services or to extend the contract performance period. Before exercising the option the government must determine whether an option is "the most advantageous method of fulfilling the government's need, price and other factors considered." If it believes it can obtain better pricing or terms elsewhere it can elect not to exercise the option.

FAR Clauses Governing Options

FAR Part 17 controls options. It generally allows inclusion of options in a contract when it's in the government's interest where the section identifies where it is not in its interest.

♦ Types of Options

There are basically two types of options in government contracts (1) those to increase quantities and (2) those to extend the terms of the contract. Options to increase quantity are covered by FAR 52.217-6, Option for Increased Quantity or 52.217-7, Option for Increased Quantity-Separated Priced Line Item. Both of these clauses include blank lines which must be filled out by the CO. Options to extend the term of the contract are governed by FAR 52.217-8, Option to Extend Services and 52.217-9, Option to Extend the Term of the Contract. FAR 52.217-8 permits extension of the contract for a maximum of six months while 52.217-9, which is the most common clause, allows the CO to extend the contract for option periods identified in the contract which are generally for one year increments.

Like the clauses used to increase quantities, those used to extend contract performance periods include blanks for the CO to fill in with required notice period and in the case of 52.217-9 the time to which the CO must give preliminary notice to the contractor of its intent to exercise the option.

In addition, FAR 52.237-3, Continuity of Services, which is not truly an option clause allows the CO to extend performance of services during the transition period after expiration of a contract for a period of up to 90 days. This clause includes a requirement to notify the contractor in writing of continuing services but does not include the same fill-in-the-blank notice requirements.

♦ Which Options Apply When

When more than one options clause may apply, the CO can choose which one to use where the one chosen can have different effects on contract pricing. If 52.217-8 is used to extend services or 52.217-6 or 7 is used to increase quantities the terms of the contract government the pricing. If 52.217-9 is used to extend the contract period the contract schedule will determine pricing. When the CO extends the contract during a transition period using 52.237-3, the contractor is entitled to be compensated its actual costs plus a reasonable profit.

When the CO has a temporary need to extend services at the end of a contract or while a new competition is occurring, two clauses are available: FAR 52.217-8, Option to Extend Services and FAR 52.237-3, Continuity of Services. Compensation under these two clauses are different: the first one maintains contract pricing for up to an additional six months while the second one allows recovery for up to 90 days of actual reasonable expenses plus profit (or fee) where the profit is not to exceed a prorate share of the fee under the contract.

Exercising Options

♦ Strict Compliance Rule

An option must be "exercised" i.e. accepted, strictly in compliance with its terms. Generally, an attempt to alter the terms or conditions of the option makes it "ineffectual." The altered terms make the attempted option exercise a counteroffer that must be accepted before it become effective. However, a restatement of terms in the option exercise that is already included in the contract will not make the exercise ineffective. An attempt to change the quantity of work under an option will generally render the attempted exercise ineffective. Also, it is a well settled rule that options must be timely exercised where the expiration of the time required to exercise an option terminates the power of acceptance. Case law has established the following attempted option exercises to be invalid: (1) order quantity different from that specified in the contract (2) alterations to the delivery schedule (3) attempted oral corrections to otherwise invalid options and (4) failure to ensure timely delivery to the contractor of the exercised option. The following are based on court or appeals board cases.

♦ Exceptions to the Strict Compliance Rule

There are a few exceptions allowed. If a contractor leads the government to believe it can exercise the option without strictly complying with the option clause the contractor will be "estopped" from asserting the strict compliance rule. Another exception is if the contract language is ambiguous then the exercise of the option is valid. Also, an exception may occur where the language purporting to exercise the option is not completely clear (e.g. the final date for exercising the option is unclear).

♦ An Option Must be Exercised in Writing

Most option clauses require that notice of intent to exercise an option and actual exercise must be provided by the government in writing. When the contract requires written notice, oral notice will generally be considered insufficient. It has been ruled that when a contractor elected to commence work after verbally discussing the work without receiving an official option exercise in writing the Board ruled the contractor was not entitled to compensation where it did the work at its own risk (*Diversified Marine Tech, Inc.*).

♦ An Option Must be Timely

An option must be exercised in the time identified in the option. If there is no time identified, it should be exercised during the performance period then in effect. An option need not be exercised by a modification to the contract to be considered timely and effective. A written notice by the CO expressing unequivocal in-

tent to exercise the option under the contract's stated terms and by the date required is sufficient for a valid option. To be effective an option must be received by the contractor in accordance with the notice requirements in the option clause.

Contractor Remedies

A contractor generally has no remedies if the government chooses not to exercise an option where the decision is at the sole discretion of the government. There are limited exceptions to this rule such as showing bad faith or was "arbitrary or capricious" on the part of government personnel. When a contractor believe an option exercise is ineffective, it must choose whether to perform the contract as if the option is valid, perform the contract under protest or refuse performance.

Continued performance. When faced with an improperly exercised option the contractor can still choose to continue to perform the contract as if the option was properly exercised. The contractor may always choose to waive the deficiencies. Just remember that if the contractor fails to timely notify the government of the deficiencies, it later may be estopped from challenging the effectiveness of the option exercise.

Performance under protest. If the contractor believes the option has been improperly exercised it must notify the government of the deficiencies in the exercise and then it can continue to perform under protest. Performance under protest brings in the contract's "Disputes" clause which requires continued performance through resolving the dispute. If the contractor prevails, it may challenge the invalid option exercise where it will be entitled to an equitable adjustment, which allows for compensation of actual costs plus profit, for a constructive change under the "Changes" clause of the contract. As discussed above, the contractor must notify the government when it believes the option was improperly exercised.

Refusal to perform. A third option when the contractor believes the option was improperly exercised is to refuse to perform the contract. Such an action can be risky. If the option was improperly exercised then yes the contractor is exempt from performance but if it turns out they are wrong, then the government may terminate the contract for default which will remain part of its past performance record and cannot be converted to a termination for convenience. The authors recommend if the option is for an increased quantity, rather than stop performance it should attempt to continue to perform the contract under protest and then file a claim with the CO.

Case Study…

RESPONDING TO A DISALLOWANCE OF BONUS, MARKETING AND CONSULTING COSTS

(Editor's Note. As a continuation of our practice to address real life issues we are providing a highly edited version of a response we prepared for our client who was confronted with two Form 1's issued by DCAA questioning bonus, marketing and direct consulting costs as a result of two years of incurred cost proposal audits. Our client chose to be critical of DCAA's actions where though it can be risky in hardening auditors' positions was intended to question their actions in the eyes of the ACO. We are disguising the name of our client calling it "Contractor" and the dollar amounts. We believe this case study is instructive in many ways: it alerts contractors to common positions we are seeing auditors taking, provides potentially effective challenges to audit positions and provides insights into helping make such payments allowable.)

Bonus Costs

♦ DCAA's Position

DCAA is questioning $325,000 of bonus expenses paid to two of its executives because "the contractor does not have adequate policies and procedures" as provided in FAR 31.205-6, Compensation for Personal Services. The audit report quotes the FAR provision: "(1) Bonuses and incentive compensation are allowable provided the – (i) Awards are paid or accrued under an agreement entered into in good faith between the contractor and the employees before the services are rendered or pursuant to an established plan or policy followed by the contractor so consistently as to imply, in effect, an agreement to make such payment." DCAA is not questioning the total amount of executive pay but rather the bonus portion of that compensation.

♦ Our Response

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

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

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

Nonetheless, the auditor imposes a criterion which is not important and fails to inquire into the more important criteria that is specified in both the FAR cost principle quoted and DCAA's own guidance. The important criteria is (1) is there a plan or policy which translates into a practice (2) how long has that plan been in existence and is the basis for the payment consistent (3) does that plan, "in effect, constitute an agreement" to make bonus payments and (4) are the current costs being questioned consistent with the plan.

In response to these criteria we assert:

(1) Yes, there is a practice in place which constitutes a plan or policy. The two executives were paid a similar bonus for five years prior to the year in question.

(2). The bonus plan has been in place for eight years.

(3). All the elements for an agreement exist.

a. Long History. There was a five year practice of computing and paying the same bonus.

b. Board of Director's Approval. We have provided the auditor copies of board resolutions approving the bonus.

c. Rational Justification. We provided DCAA the rationale for the bonus which clearly represents a reasonable business practice. Rather than pay a large salary for the executives they take a comparatively low salary and augment it with a bonus when the company's cash flow allows for it. Contractor is careful not to exceed total comparable compensation levels for the two executives of similar companies.

(4). The bonus is consistent with criteria of FAR 31.205-6. The criteria includes the following three elements"

a. "paid or accrued under an agreement entered into in good faith between contractor and employees." The long history of payments of the bonus clearly establishes both an agreement as well as an established policy. FAR 31.205-6 does not require the agreement or policy be in *writing* as implied by the audit report.

b. "Either before services are rendered or pursuant to an established plan or policy." There is a consistent approach to computing what those payments are.

c. "The plan or policy is followed by the contractor so consistently as to imply, in effect, an agreement to make such payment." The eight years of computing and paying the same bonuses amount to a consistent policy.

Marketing Costs

♦ DCAA Position

DCAA is questioning $120,000 of marketing costs. Its audit report states "while testing, Contractor was unable to show how the costs in question were in accordance with FAR 31.205-1, Public Relations and Advertising Costs." The auditor recognizes the costs are for marketing – "The majority of these costs were for marketing expenses." However, DCAA quickly changes its characterization of these costs after it makes the observation that the purpose of the marketing costs

are to promote sales to the US military. Once that observation is made these costs are considered to be Public Relations and Advertising costs, not sales and marketing or bid and proposal costs. The cost principle addressing advertising and PR costs – FAR 31.205-1 – normally makes these types of costs unallowable except under certain circumstances quoted by the audit report. The audit report asserts the "marketing" costs "do not meet the FAR criteria" for allowable advertising and PR costs and are hence unallowable.

♦ Contractor's Response

During the audit Contractor explained that it was far more cost effective to use an outside firm rather than build up in-house capability to provide marketing and bid and proposal assistance. The firm hired to provide this assistance was tasked by Contractor to find business opportunities in both the state and federal market place and once identified, assist in the proposal creation process. Contractor provided the firm's published material and emphatically explained that the marketing firm's services did not at all include any advertising or public relations functions nor was such functions a part of its expertise. Contractor states DCAA was remiss in not reviewing the mission of the firm.

There is no explanation as for why the costs were characterized as advertising and public relations costs which are mostly unallowable rather than "sales" costs which are addressed in FAR 31.205-38, bid and proposal costs covered in FAR 31.205-18 or even long range marketing costs found in FAR 31.205-12. We believe this erroneous classification of the nature of the activities provided by the firm resulted in applying the incorrect cost principle which has nothing to do with the activities expended. We can only conclude the auditor had a preconceived idea the costs incurred should not be allowed and then created an erroneous category and accompanying cost principle that would tend to support that preconceived idea.

The assertion that marketing costs incurred to promote military sales are unallowable is contrary to case law. A long history of court cases have concluded that whether sales and marketing or B&P costs are incurred to promote military sales, commercial sales, foreign sales or other sales is irrelevant to their allowability (e.g. *Federal Electric Corporation*, ASBCA No. 11324; *Daedalus Enterprises Inc.*, ASBCA No. 43602). All such costs are considered allowable because they contribute to expanding contractors' cost base which, in turn, benefits the government by lowering indirect costs.

The auditor seems to have taken advantage of the broad description of "selling activities" found in FAR 31.205-38 that can include advertising and public relations, bid and proposal, market planning and direct selling to limit the activities of the marketing firm to only those of advertising and public relations at the exclusion of the only activities it performed. Though we will avoid a detailed definition of the above listed activities, it should be stressed that the firm does not perform any activities defined as advertising and public relations but their functions clearly fall under the definitions of direct selling, B&P and market planning, all of which are primarily allowable costs.

Consulting Costs

♦ DCAA Position

DCAA is questioning $90,000 of consulting costs. The audit report states the reason the costs are being questioned is because Contractor does not have "adequate supporting invoices and agreements for consulting costs" per 31.205-33. In support of its position DCAA quotes the FAR 31.205-33, Professional and Consultant Services where we quote relevant sections below.

♦ Contractor's Response

Contractor provided the following facts. It states that Consultant consists of one engineer who worked solely on one contract in one location. The Engineer provided monthly reports of his activities which were reviewed by Contractor personnel. In spite of offers for DCAA to examine the actual work product - monthly reports – and to have Engineer available for interviews DCAA refused, stating they should be sent to DCMA. Contractor concludes there was ample evidence provided to DCAA to show there was adequate documentation to support the consulting costs – verification the costs were incurred, reconciliation of the invoices to payments made, adequate evidence of work product in the form of Consultant monthly reports and access to Contractor personnel who supervised Engineer and approved his invoices. Contractor states DCAA was remiss in not examining the work product or interviewing Contractor personnel responsible for overseeing the consulting work.

We responded that we strongly believe the consulting agreement, submitted invoices and work product met

all the criteria of allowability as quoted in the DCAA audit report.

Consulting Agreement. (1) FAR requires "details of all agreements (e.g. work requirements, rate of compensation and nature and amount of other expenses if any…" The contract with Consultant clearly meets the conditions for an agreement specified in the FAR. The agreement explicitly details the work requirements and rate of compensation. Additional expenses are not identified since the work was to benefit only one contract and was to be performed in one location. Additional information is also provided in the agreement such as detailed descriptions of individual tasks, approval requirements, estimated period of time required, timeliness of submitting invoices and normal provisions such as insurance, indemnification, IP considerations, termination provisions, resolution of any disagreements.

Invoices. FAR requires "(2) Invoices or billings submitted by consultants, including sufficient detail as to time expended and nature of the actual services provided." Each submitted Consultant invoice provided all information about hours worked, hourly rate, total owed and nature of work. In the invoices provided to the government showed consistency with provisions in the consulting agreement and were approved the CEO.

Adequate Work Product. FAR requires "(3) Consultants' work products and related documents, such as trip reports, indicating persons visited and subjects discussed, minutes of meetings and collateral memoranda and reports." We provided several monthly reports that were submitted by the Consultant and showed they were reviewed and approved each month by Contractor.

Interaction with DCAA

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

STATUTE OF LIMITATION ON COST RELATED CLAIMS

(*Editor's Note. We have been reporting on recent cases in the GCA REPORT where the six year statute of limitations has affected the ability of the government to recover questioned costs resulting from incurred costs audits or cost impact analyses of CAS non-compliances. This is particularly significant in the light of the backlog of DCAA and other agency incurred cost audits. We have received numerous inquiries about the practical impact of these recent cases where we were glad to come across an article addressing this issue written by Tom Lemmer and Tyson Bareis of McKenna Long & Aldridge in the June 25 issue of Federal Contracts Report.*)

Government contract law has been changing very rapidly in the last year on the application of the Contract Disputes Act's six year Statute of Limitations (SOL) to cost allowability and accounting claims (referred to as "cost claims") as a result of several case decisions. The developments are significant because they may time-bar certain government claims against contractors meaning they may be prevented from recovering claimed costs from contractors.

SOL and Its Application to Cost Issues

The CDA's Statute of Limitations bars the government and contractors from bringing claims more than six years after the claim "accrues." Under FAR 33.201 a claim accrues on "the date when all events, that fix the alleged liability of either the government or the contractors and permit assertion of the claim, were known or should have been known."

The SOL has increased in importance as cost claims are delayed due to a massive DCAA backlog of audits which has delayed the issuance of timely audit reports and, in turn, issuance of contracting officers' final decisions on DCAA opinions of such issues as cost accounting standards (CAS) compliance, incurred cost proposals (ICPs) and contract proposal issues many years after contractors have submitted documents to the government. Historically, the government has justified the timeliness of claims resulting from tardy DCAA audits using a variety of arguments such as the claim does not accrue until DCAA audits the submittal or the CO receives notice of the facts that underlie the claim. However, the recent cases discussed here have made such arguments invalid where now the trend is the SOL clock begins to

run upon the contractor's submission of information to the government – whether that submission is made to DCAA, the CO or otherwise.

Four Recent Cases

1. *Sikorsky Aircraft Corp vs. United States (105 Fed. Cl. 657).* In response to the argument that the SOL clock starts only when the CO has knowledge of the underlying facts, the Court rejected this argument stating the government could delay the CAS administrative process by "indefinitely simply refraining from issuing a determination of non-compliance or requesting a cost impact." The Court did not rule on which party's knowledge starts the SOL where whether DCAA's or the CO's knowledge remains an open issue.

2. *Raytheon Co. (ASBCA No. 57576, 2012 WL 6853466).* The government sought to recover increased costs resulting from Raytheon's inclusion of alleged unallowable costs in its ICP. Raytheon claimed more than six years had passed since its submission of certain relevant ICPs and thus the government's claims were precluded under the SOL. The Board sided with Raytheon claiming the government has knowledge or should have knowledge of the unallowable costs when Raytheon submitted the ICP not when DCAA actually audited it. It concludes that DCAA knowledge of the facts underlying a claim will be imputed to the government as a whole and the contracting officer's knowledge alone "is not dispositive" of when the government knew or should have known of the facts.

3. *Raytheon Missile Systems (ASBCA No. 58011).* The government claimed $17 million for the contractor's failure to apply a lower G&A rate to subcontractor costs which it claimed constituted a CAS non-compliance. Raytheon disclosed to the government in 1999 the subcontract costs and related G&A burden at issue.. The Defense Contract Management Agency audited the subcontract costs in 2005 to determine whether Raytheon applied the proper G&A rate and waited until November 2011 to assert a claim against the contractor. Raytheon challenged the timeliness of the claim where the government responded its claim was timely arguing that when the government audited the Raytheon's proposal in 1999 it did not recognize the subcontract costs received an improper G&A burden and in any event the CO was not aware of the issue until a later date. The Appeals Board sided with Raytheon stating the alleged CAS violation "was perfectly knowable in 1999 because the contractor disclosed the underlying facts about its subcontractor burden to the government at that time." The Board added that at any rate, the government was aware of the relevant facts in August 2005 and as a result the government's Nov. 2011 claim was untimely.

4. *Raytheon Space & Airborne Systems (ASBCA No. 57801).* The government asserts claims against the contractor amounting to over $7.5 million related to alleged increases in costs resulting from several contractor initiated cost accounting changes occurring in 2004 and 2005. The CO issued four final decisions between July and October 2011 seeking to recover increased costs resulting from the accounting changes. The contractor argued these claims were not timely because the claims accrued when the contractor provided notice to the government of the changes while the government argued the claims were timely because they accrued only when the government had sufficient information to accurately calculate the cost impact of the change. The Board largely agreed with the contractor holding the claims accrued when the government had notice the change resulted in an adverse impact which occurred when notification of the changes occurred.

Five Lessons From the Cases

1. *The Raytheon cases, especially the last two, confirm that DCAA audits and/or contracting officers' knowledge is not necessary for a claim to accrue.* The cases confirmed that it is the contractor's supplying information to the government not what the government does or does not do with that information that triggers the SOL clock.

2. *The cases explains the FAR's "knew or should have known" standard for a claim to accrue.* Prior to these cases there was little guidance on when the government knew or should have known of the facts leaving contractors to speculate as to the impact on the SOL on submissions or disclosures made to the government. As a result of the two later Raytheon cases, contractors can be confident in looking at the objective availability of information rather than the subjective knowledge of government personnel to determine when a claim accrues. So, once facts become reasonably available to the government rather than remaining concealed or otherwise unknowable, a government claim will accrue regardless of whether anyone within government has assessed the facts.

3. *The cases provide clear guidance on when claims related to CAS issues accrue.* The test for a claim accrual here is

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when did the government know or reasonably should have known that it had a basis to seek a cost adjustment because of an accounting change. Raytheon Space & Airborne provides guidance on how this test should be applied where the Board held a claim accrues from a CAS violation or change when the government reasonably should have known of an adverse cost impact. The government's mere ability to assess the contractor's accounting information was not sufficient for claim accrual – the government is not required to independently investigate the cost impact of an accounting change. However, a government claim will accrue when a contractor notifies the government of an adverse cost impact, even if the adverse impact is characterized by the contractor as "immaterial," even though a general dollar magnitude calculation (GDM) has not been submitted or the dollar impact is later revised by the contractor. Under the standard put forth by the Board, claim accrual often occurs upon a contractor's submission to the government of some form of cost impact statement, whether it applies as a GDM or not. Raytheon Space & Airborne also makes clear that the government claim accrual can also occur prior to the submission of a cost impact statement.

4. *The cases confirm that updates to cost impact calculations do not restart the SOL clock.* Claim accrual does not depend on the degree of detail provided, whether the contractor revises the calculations later or whether the contract characterizes the impact as "immaterial." The Board went on to say the government's claim accrued when the government knew or should have known of "at least some adverse impact" even if the exact amount of that impact was not yet known or would later be revised.

The authors bring up the point that DCAA may attempt to delay acceptance of incurred cost proposals so as to lengthen the SOL period. Many of our readers are familiar with DCAA's tendency to assert ICP submittals are not complete or otherwise auditable where they tend to reject the submittals and demand contractors resubmit and recertify them. One potential reason for this trend is the government's belief that such delays will restart the SOL clock. The authors state though the Raytheon Space & Airborne case addressed CAS issues, it may preclude the government's strategy of extending the SOL clock in ICP or system non-compliance audits.

5. *After the Raytheon cases, the forum selected to hear cases is critical.* Whereas ASBCA cases rely on earlier Board decisions the Court of Federal Claims does not rely on ASBCA precedent where Court decisions are less cl ear. The authors state that if SOL arguments are anticipated contractors should strongly consider appealing CO decisions before the ASBCA rather than the Court of Federal Claims.

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