GCA REPORT

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NEW DEVELOPMENTS

Proposed Rule Removes Per Diem Cap

The FAR Council has proposed an amendment to FAR 31.201-3 (general reasonableness criteria) and FAR 31.205-46 "Travel Costs" to eliminate the current limit on reimbursement of lodging, meals and incidentals. The change seeks to replace the current provision that bars contractors from being reimbursed any travel costs in excess of Federal Travel Regulations (FTR), Joint Travel Regulations (JTR) or the Standardized Regulations (SR). Under the new rule, there would be no blanket limit on reimbursement of travel-related expenses beyond what is considered "reasonable".

Contractors have long maintained the FTR limitation was both unfair because contractor personnel were unable to obtain the same discounted rates as government employees and burdensome to keep two parallel travel systems – one for commercial business and one for government business. A 1994 proposal was withdrawn that would have made FTR, JTR and SR baseline amounts but allow contractors to propose alternative maximum per diem rates. With a new head of the Office of Federal Procurement, industry pressed for a reconsideration of the matter and the new proposal is the result. The stated justification for the new position is (1) the FTR was originally intended to apply to government employees only (2) removing the per diem cap will reduce administrative costs and (3) the new rule is more consistent with the commercial marketplace.

Proposed FAR Rule Will Lift Relocation Cost Ceilings

The FAR Council is proposing to amend FAR 31.205-35, "Relocation costs". The proposal will allow contractors to have the option of claiming employee relocation costs on an actual basis, a negotiated lump sum basis or a combination of the two methods. Currently contractors are only allowed the actual cost method.

In addition, instead of the FAR-imposed ceilings on such items as mortgage and rental payment differentials, maintenance of a former residence, purchase of a new residence, etc. the new rule would eliminate these provisions and have reimbursement of relocation costs governed by reasonableness criteria in FAR 31.201-3 and corporate relocation policies. Also, the proposal would make allowable under federal contracts two types of expenses currently unallowable: (1) "tax gross-ups," payment for increased employee income and social security taxes that result from reimbursed relocation costs and (2) payments for spouse employment assistance.

New Compensation Cap; Proposal to Extend Cap to All Employees

There are two separate developments related to executive compensation:

1. The Office of Federal Procurement Policy issued a notice on May 26 that raises the executive compensation benchmark to $342,986 from the current $340,650 level. The cap was established by the 1998 Defense Authorization bill that imposes a ceiling on both defense and non-defense contracts according to a formula based on the median salary of senior executives in all corporations with annual sales in excess of $50 million, regardless of the size of the company. Currently, the benchmark applies to the five most highly compensated employees in management positions at each home office and each segment of the contractor, whether or not the segment reports to the contractor's headquarters. The increase was a result of commercially available surveys of executive compensation.

2. The Defense Department Inspector General has drafted proposed changes to extend the ceiling on allowable compensation to all contractor employees – not just the top five. Currently the cap applies only to the top five most highly compensated executives in each business segment of a contractor. The IG believes this is a huge loop hole because the government ends up paying for other employees who are not within the top five executive category. Their proposal is to establish a ceiling applying to all employees.

DOD Issues Best Practices Guide on Past Performance Information

(Editor's Note. Considering the importance of past performance information in award decisions, the following guidance acquisition officials are asked to follow should be the standard contractors use to determine whether they are treated fairly and openly.)

A joint Defense Department team has issued a final version of its guide intended to be a practical reference tool on key techniques and practices for collecting and using past performance information (PPI). The 17 page guide, available at http://www.acq.osd.mil, includes a top ten list:

1. FAR and DFARS rules apply to all PPI. They require contractors be provided the opportunity to comment on adverse PPI on report cards as well as other PPI gathered under less formal methods.
2. PPI is for official use only and should be so marked.
3. Performance assessment begins with solicitation evaluation factors and continues through contract performance and the form and content of the assessment should be consistent.
4. The narrative is the most critical aspect of PPI assessment.
5. Performance assessment is the responsibility of the program/project/contracting team that considers the contractor's input – no one office or organization should independently assess performance.
6. Performance assessment should be developed throughout the period of contract performance and not held to the end of the performance period.
7. Use and evaluation of the PPI for a specific acquisition should be tailored to the needs of that acquisition and should be clearly identified in the solicitation.
8. Source selection officials should use the most relevant, recent PPI available in making source selection decisions and they must consider updated information provided by the contractor regarding relevant PPI.
9. Personnel collecting PPI for a particular source selection should consider whether the data received comes from reputable and reliable sources.
10. The government should share all relevant PPI with contractors as part of the past performance evaluation during the source selection process and must share adverse PPI on which contractors had not had an opportunity to respond.

In addition the guide announces a five tier rating system: (1) "Exceptional" for performance meeting all contract requirements and exceeds "many" of them (2) "Very Good" for performance meeting all contract requirements and exceeds "some" of them but which have contained minor problems for which corrective action was taken (3) "Satisfactory" for performance meeting all contractual requirements but contains "minor" problems for which corrective action was taken (4) "Marginal" for performance not meeting all contract requirements and which contained "serious" problems for which contractor has not yet identified corrective action and (5) "Unsatisfactory" for performance that does not meet most of the contract requirements and recovery is not likely in a timely manner.

DCAA to Review Internal Controls Over Indirect Cost Every Three Years

In response to a critical Department of Defense Inspector General report asserting that the Defense Contract Audit Agency does not provide adequate coverage of contractors' "internal controls system for recording indirect costs", the audit agency is expanding its audit coverage. Though it disagrees with some of the DODIG conclusions (e.g. the IG spent an inordinate amount of hours attempting to find unallowable costs DCAA failed to find at sampled contractors resulting in a trivial "less than one tenth of one percent"), it has instituted a few changes to ensure the controls over recording indirect costs and screening for unallowable costs is more effective.

DCAA will test contractors internal control system every three years. It will also institute "dual-purpose testing" where the normally separate steps of testing controls and testing transactions will be combined. C*ontrol testing* seeks to have a reasonable assurance the contractor's internal control system is working as intended and substantive *transaction testing* seeks to determine whether actual accounting transactions and balances are valid. Auditors are now encouraged to achieve both objectives simultaneously. This will be achieved through "dual purpose testing" where a sample of transactions will be used for both assessing control risk and testing whether the recorded monetary amount of transactions are correct.

The result is likely to be greater scrutiny over both internal controls and transactions. In the past, once a comprehensive review of the contractor's indirect/other direct cost practices has been performed, it usually served as a baseline for establishing the scope of other reviews which tended to be limited to audit of significant system changes and other areas identified as high risk. Now, the audit guidelines call for testing of internal controls "at least every three years to ascertain there are still no control weaknesses" (MRD 99-PIC-057R).

DCAA Issues Audit Guidance on Contractors Who Work at Home

The Defense Contract Audit Agency recently issued audit guidance on contractor employees who work at home (WAH). Auditors are to first determine the materiality of costs associated with WAH. The determination of materiality should include such factors as number of contractor employees in a WAH program, the dollar amount of the WAH labor and the mix of contracts.

If costs are material, the contractor's written policies and procedures covering the program are to be reviewed to determine if there are adequate controls in place. These policies and procedures should address, at a minimum, employee's eligibility for the program, employee's working status, approval requirements, employee work schedule and performance evaluation, equipment provided and timekeeping procedures. The guidance indicates a good system will identify specific tasks to be performed and the employee's performance should be noted on the task document. The guidance goes on to say periodic meeting at the contractor's work site should be required to allow employee and supervisor to discuss work progress, assign new tasks and evaluate work performed. In addition, WAH employees should be required to work a mutually agreeable set of core hours and submit timecards in accordance with the company's established timekeeping practices. If the costs are material and the contractor does not have adequate written policies and procedures, the guidance says the contractor should be cited for a labor accounting system deficiency.

Guidance for reviewing WAH states that during a floorcheck, if several employees are identified as not present due to WAH, the contractor should be asked to provide its policies and procedures and a list of employees participating in the program to determine materiality. At the same time, employees' supervisors should be interviewed. The auditor should also interview employees over the phone to determine if they have knowledge of WAH procedures and discuss specific types of work being performed along with the related labor charge numbers (MRD 99-PIC-064R).

FAR Council Issues FAR Changes

A recent change to the Federal Acquisition Regulation in the form of Federal Acquisition Circular 97-12 was recently released (Fed. Reg. 32740). Significant changes includes:

Competition Under Multiple Award Task and Delivery Order Contracts. In response to several critical reports that multiple award contracts are preventing adequate competition and excessive use of sole-source awards of individual task orders, the final rule amends FAR Part 16 to increase "fair opportunity" for all awardees of the contract. For all orders more than $2,500 contracting officers are required to ensure there is a fair opportunity for each contract awardee to win a task or delivery order. The CO is given broad discretion in determining how to provide a fair opportunity and suggests relevant factors as past performance on earlier tasks under the same contract, quality of deliverables, cost control, price and cost be considered. If the need for supplies or services are urgent or if only one contractor is able to supply the item because it is unique or highly specialized, consideration does not need to be given to all awardees.

Use of Brand Name Item Descriptions. FAR Parts 11 and 17 are amended and a new clause (52.211-6) is added that indicates use of an acknowledged brand name or equal will be permitted in certain circumstances where there are firm requirements. The change emphasizes that the use of performance specifications is still the preferred method for describing government needs. The new "brand name or equal" purchase description must include a description of the important physical, functional or performance characteristics of the brand name item that an "equal" item must meet to be acceptable. Earlier proposed language giving COs flexibility to use "brand name – no substitute" and "brand name or target" were dropped.

Y2K Compliance. FAR 39.101 is amended to prevent use of government funds for newly acquired information technology that is not Year 2000 compliant.

DCAA Recovers Questioned Costs on Other Contracts and Other Cost Elements

The Defense Contract Audit Agency issued guidance on what to do when it issues a Form 1 on a contract that no longer has sufficient billing to reimburse the government. When DCAA disallows either an indirect or direct cost, it often issues a Form 1 (Notice of Costs Suspended and/or Disapproved under Cost Reimbursement Contracts). DCAA issued guidance on how to recover these questioned costs. The guidance uses two examples: when $200,000 of direct labor is questioned and all direct labor has been billed but there is still other costs (e.g. subcontractors), the government may collect the questioned direct labor costs from the other cost element. For the same $200,000 of direct billings and there is no more active billing, the guidance advises its auditors that courts have ruled the government has the common-law right to offset contract debts against payments due on other contracts. Disapproving costs on another contract is to follow a demand for payment by the ACO and only if the contractor does not make payment within 30 days can DCAA authorize disapproval of the cost (DCAA MRD 99-PIC-050(R).

DOD Amends its Weighted Profit Guidelines to Consider Performance-Based Contracts

The Department of Defense issued a proposed rule that will modify the weighted guidelines of computing profit objectives by adding contracts with performance based payments to the type of contracts that affect a contractor's cost risk. Under the DOD profit guidelines (DFARS 215.404-4) COs are required to use the weighted guidelines to develop a pre-negotiation profit objective on most negotiated contracts requiring a cost analysis. This method focuses on three profit factors: performance risk, contract type risk and facilities capital employed. The resulting calculations from these three factors become part of the profit objective. Under the contract type risk, the calculations include an assessment of the degree of risk under various contract types that are adjusted by the method of financing (e.g. progress payments or no financing). The proposed rule would add contracts with performance-based payments (i.e. where payments are made on the basis of completion of certain milestones or other agree-to results) to the type of financing and will add evaluation criteria COs should consider when determining a value for contract type risk associated with contracts using performance-based payments.

DCAA Limits Use of Their DRI Price Escalation Survey

(Editor's Note. The next time you are considering asking your local DCAA office for a copy of their DRI/McGraw Hill economic forecasts for pricing your proposals, make sure your request is complete because it may be the last one honored.)

DCAA has issued guidance on use of economic indexes. Though it does not require a particular survey to be used by contractors, DCAA continues to use the DRI/McGraw-Hill's proprietary economic forecasting data in evaluating contractors' estimates of future costs in their pricing proposals, rate agreements and estimates of costs at completion. In an apparent move to lessen requests of its copies, DCAA provides that a one-time request from contractors and other government procurement offices for economic forecasts should be honored if they are for a specific forecast and for use in proposals reviewed by DCAA. Recurring requests and requests for extensive lists of forecasts *(we are guilty as sin)* should not be honored. In the case of these requests, the guidance states contractors and other government offices should be encouraged to obtain forecasts directly from a forecasting service provider (MRD 99-OTS-062(R).

CASES/DECISIONS

Can't Recover CAS Non-Compliance Impact on Subcontacts and Some Fixed Price Contracts

From 1986 through 1989 ACA performed numerous CAS-covered contracts as a prime contractor for DOD and as a subcontractor for DOD prime contractors. During an incurred cost audit, DCAA discovered that ACA had omitted certain material costs and other direct costs that should have been in its overhead allocation bases resulting in inappropriately high overhead cost rates and an assertion it was in noncompliance with both its disclosed practices and CAS 401, 410 and 418. ACA did not dispute the omissions and it (1) corrected its overhead rates for future applications (2) provided a cost impact of its errors on its cost-type contracts (3) revised its incurred cost submittals for cost type contracts to account for the error and (4) asserted the error had no impact on its firm fixed price contracts because they were not affected by the error. ACA stressed the error had no impact on its fixed price contracts because the budget used to calculate its forward pricing rates included the missing direct costs in the allocation bases. The government did not accept ACA's response and issued a decision requiring a cost impact on all its CAS-covered contracts and subcontracts, including fixed price contracts and alleged the contractor owed the government over $13 million in cost impact from the noncompliance and interest. In its appeal, ACA said (1) there should be no adjustments on fixed type contracts since there were no increased costs paid and (2) the government's "lack of privity" on its subcontracts prevented attempts to recoup costs on its subcontracts.

The appeals board sided with the contractor. The Board said that FAR 52.230-3 allows for a cost adjustment when a non-compliance results in "increased costs paid by the government". For fixed price contracts, the CAS Board has defined "increased costs paid" as the difference between the contract price agreed to and the contract price that would have been agreed to had the contractor proposed in accordance with CAS. Under this interpretation, the government is entitled to an adjustment only when the noncompliance allocates *less* cost to the fixed price than if the CAS-compliant practices were followed. It concluded that the government is not entitled to a price adjustment on a firm fixed price contract when the non-compliant practices *increases* rather than *decreases* the costs allocated to those contracts.

In addressing whether the price adjustment applies to subcontracts, the board ruled the government cannot bypass a prime contractor and hold a subcontractor directly liable for any CAS non-compliances. It ruled the government lacks jurisdiction against the subcontractor. In order to avoid the subcontractor being able to violate CAS with impunity, the board stated the government's remedy is against the prime contractor (Astronautics Corporation of America, ASBCA 49691).

(Editor's Note. Legal commentary on this case makes the point that since the CAS flowdowns make subcontractors CAS covered but puts liability on the prime contractor, the prime contractor would be well advised to draft indemnification clauses that would obligate the subcontractor to indemnify the prime contractor - dollar for dollar - for amounts determined to be owed by the prime for CAS violations caused by the subcontractor. In exchange, the prime contractor would agree to sponsor the subcontractor's appeal.)

Learning Curve Benefits Should be Allowed in Spite of Uneven Pricing and Exercise of Options

A contractor was awarded a contract to develop and supply power sources for a missile launcher that included two options where the contracted unit prices for each successive option was lower. Both options were exercised and during performance work on Option 2 the contract was terminated before anything was produced. The contractor requested an equitable adjustment for labor costs for the portion of the contract not terminated claiming that had there been no termination, its labor learning curve would have reduced the average cost per unit when amortized over the entire length of the contract. *(A learning curve or experience curve refers to the tendency for average unit costs to decrease as more units are produced.)* The adjustment was to compensate for increased labor costs due to the fact lower rates were not realized.

As we previously reported, the government and the appeals board ruled against the contractor. They argued that the contractor could not have expected to amortize its labor learning costs over the entire contract because it set different unit prices for the three stages of the contract and the Air Force was not required to exercise contract options.

The Federal Circuit Court of Appeals reversed the ASBCA decision, stating it erred in applying the rule that unlevel pricing precludes recovery. The Court stated that prior board cases have long recognized unamortized labor learning costs are a legitimate recoverable cost from a partially terminated contract. Because Option 2 was exercised it should be considered a continuation of the contract and the contractor can expect an adjustment to its earlier labor costs. Neither the fact the option was continued or pricing was not level should automatically prevent recovery. However, the Court added that is the contractor's responsibility to actually experience positive learning curve results during performance of the interrupted portion of the contract (VHC Inc. vs. the Air Force, US Court of Appeals for the Federal Circuit No. 98-1327).

Can't Recover for Ruling Employee Was Underpaid

(Editor's Note. Under the Service Contract Act a service contractor must pay for the particular job being performed in accordance with Department of Labor established wages. The solicitation usually contains the classification information bidders can rely upon to price their contract and if the rates for these classified jobs increase, the contractor is entitled to an equitable adjustment to cover the increase. It is common, however, for certain classifications to not be included in the solicitation and the time to obtain a Department of Labor classification is often too long to prepare a timely proposal. The result is the contractor must guess. The following addresses whether the contractor can get its money back if it guesses too low.)

Contractor had a janitorial services contract covered by the SCA. The solicitation required an on-site supervisor but did not contain any wage classification for the job. The contractor made its own assumptions on what would be an appropriate wage and used it in its proposal. Several years into the contract, the Labor Department ruled the supervisor should have been paid at a higher "working custodial supervisor" level. The contractor did not fight the issues and instead asked for an equitable adjustment in its contract price to pay for the additional wages. The government refused to pay arguing the contractor should have sought a clarification of the nonlisted category under the "conforming procedure" provision of the SCA.

The board of appeals expressed sympathy for the contractor but still ruled the government does not have to reimburse the contractor. The Board said the payment to the unclassified worker did not qualify since the on-site supervisors were not classified in the solicitation. The Board recognizes the problems contractors face when they cannot obtain a prompt, pre-bid clarification of labor classifications forcing them to either guess too low and foot the bill or guess too high and risk being non-competitive in price. Though it recognizes the problem it still ruled the contractor has the duty to initiate "conforming procedure" for clarifications and if it fails to do so it must pay the increase (Spotless Janitorial Services v. GSA, (GSBCA No. 14651).

Extra Credit Allowed in Evaluating Best Value Procurements

In a best value procurement, the solicitation called for submission of a financial resources plan covering, among other things, advanced payments. The solicitation said the plan would be evaluated as part of the technical plan which was significantly more important than the management or past performance factors. Interlog proposed to bill the government when cash was advanced while the successful awardee offered to bill the government later after it reconciled underlying expense reports. The awardee received extra credit for their approach for delayed billing for cash advances while Interlog, whose proposal was fully compliant with the requirements, did not get the extra credit.

Interlog protested the award on the interesting grounds that the buying agency had reserved too many evaluation points for proposals that exceeded solicitation requirements that unfairly prejudiced those offerors that merely met requirements. This approach, they stated, amounted to use of an unstated evaluation criteria.

The GAO rejected the protest. Under a best value solicitation, the evaluation of proposals is not limited to determining technical acceptability but can be further differentiated by considering how much they exceed the minimum requirements or will better meet agency needs. They concluded an agency is entitled to give additional evaluation points – extra credit – for proposals that exceed solicitation requirements (Interlog Inc. GAO, B-282139).

Must Demonstrate "Substantial Chance" of Winning to Reverse an Award

(Editor's Note. The following case provides some useful guidance when it is worthwhile to protest an award – make sure the government made more than a minor mistake and you had a "substantial chance" of winning if not for the mistake.)

Alfa Laval and Westfalia were the only two bidders on a competition to supply purifiers to the Navy. In its evaluation the government failed to notice that Westfalia's product was in technical noncompliance due to not meeting a vibration test requirement and gave the award to Westfalia who's bid of $14.4 million was $5 million lower than Alfa Laval's bid. Though it did not dispute the mistake, the government and court found the mistake wasn't big enough and the price difference was so large that even if the mistake had not been made Alfa Laval would not have had a "substantial chance" of winning. Alfa Laval appealed the decision.

The Court of Appeals disagreed and concluded that Alfa Laval had a substantial chance of winning. The COFC disapproved of focusing solely on price. It found that only Alfa Laval submitted the bid meeting all government requirements and that its offered price was lower than the price it charged in prior procurements (Alpha Laval Separation, Inc., CAFC No. 98-5087).

QUESTIONS & ANSWERS

Q. We are a small business and recently acquired a company that uses a calendar fiscal period while our fiscal year ends May 31. How do we handle calculation of our indirect rates? We were told that the cost accounting standards limit a fiscal year to 15 months. Is this true?

A. Last question first – since you are a small business you are not covered by CAS. Though government often uses CAS as a yardstick for proper cost allocation methods for companies not CAS covered, CAS 406 (which limits a new fiscal year to 15 months) would not apply here since the Federal Acquisition Regulations do not require the 15 month rule. In this case you can use 17 months. As for proper handling of rates, follow your usual methods of allocating costs but be sure to use 17 months of costs in both the pool and bases.

Q. We inadvertently used a higher billing rate than the ceiling rate included in our contract on one of our cost type contracts and DCAA has written us a letter that it is recommending recision of our direct billing practices. Can we challenge this?

A. We have seen this a few times and DCAA usually makes the claim they are rescinding direct billing privileges on the grounds the contractor does not properly "brief their contracts". The right to withhold direct billing privileges is administratively left to the discretion of DCAA. About your only defense, which we have successfully used, is to quote their own guidance.

In a widely distributed letter to contractors, DCAA identified the five criteria a contractor should demonstrate to be allowed to direct bill its vouchers to the Defense Financial and Accounting Services as well as the four criteria to rescind such privileges. Though adequate briefing of contracts was considered a criteria for direct billing it is absent from one of the four factors to rescind the privilege. We have been successful in bringing this memo to their attention (there is a constant flood of memos and few auditors know them all) and they have reconsidered their decision in a couple of cases.

Q. We are an engineering firm and include our legal costs in our indirect cost pools. We have several lawsuits related to professional liability cases and want to know whether we can continue charging our indirect cost pools.

A. Though you are correct to charge many of your legal costs indirectly – either to G&A for costs related to the company as a whole (e.g. board of director issues) or overhead for legal costs related to supporting contracts (e.g. employee discharges) – indirect charges to the type of lawsuits you identify (e.g. errors and omissions, professional negligence, etc.) are likely to be challenged. When legal costs are significant, auditors commonly examine these accounts and look for costs in indirect pools that can or should be charged directly to commercial projects and hence not to government work. When they find such costs, they generally disallow them, citing FAR 31.202 (Direct Costs) and CAS 418 (Allocation of Direct and Indirect Costs) as regulatory "evidence" that such costs should be charged direct. Their main point is that costs that *can* be directly identified with a commercial cost objective *should* be charged to that cost objective. When challenged, DCAA commonly refers to a case (e.g. FCM) that ruled legal costs related to a contract should be allocated to that contract and not included in a pool that is allocated to other contracts.

Though we strongly disagree with this position (too detailed to recount here) and are working with a client to challenge these positions, it is unlikely that DCAA will change its position without a court decision. If you are charging these costs to an indirect cost pool and they are material, DCAA will likely disallow them during their audit. If you are interested in the grounds we are putting forth to challenge DCAA's position (e.g. no clear cost objective, violation of CAS 401 and 402, CAS Board leaves greater discretion to contractors than FAR and CAS takes precedence over allocation issues, etc.) give us a call and we will provide them.

NEW/SMALL CONTRACTORS

Some Basics of Defective Pricing

About ten years ago, defective pricing audits were a major focus of government contracting officers and auditors. Whereas most of the attention was on large contracts (after all, that was where there was the greatest dollar return for the effort) with little attention on subcontracts, we are seeing a significant increase in auditing not only smaller contracts but also subcontracts worth as little as $500,000. The increased attention on smaller contracts and subcontracts is likely a result of less audit demands on auditors' time and periodic DODIG reports that DCAA is not doing enough defective pricing reviews. Whatever the reason, contractors with little or no experience in defective pricing audits (or the more euphemistic title "post award reviews") need to get up to speed. We thought it would be a good time to briefly discuss the basics of defective pricing and what to expect from a defective pricing audit.

The Truth in Negotiations Act (TINA) covers defective pricing. TINA requires prime contractors and subcontractors to submit cost or pricing data for contracts or pricing actions (e.g. a contract change or modification) in excess of $500,000 and to certify the data is accurate, complete and current. A waiver to this requirement exists under one of five conditions: (1) adequate price competition exists (2) commercial items are acquired (3) prices are set by law or regulation (4) a waiver is granted when the government deems prices are fair and reasonable (e.g. submission of "other than cost or pricing data") or (5) a modification is made for acquisition of a commercial item. We recommend contractors seek one of these waivers whenever possible. What is and is not "cost or pricing data" and when and how this data should be brought to the attention of the "government" is a source of almost unending litigation. For example, cost data refers to facts (e.g. actual labor rates, hours expended, price quotes from vendors, records of incurred costs) while estimates and judgement (e.g. budgets, profit plans, methods of performance) are not considered facts and hence not data that must be divulged (though the facts upon which estimates and judgements are based are considered data).

Even though the contractor signed a Certificate of Current Cost or Pricing Data the contractor may have inadvertently included "defective" data in the proposal that the government relied upon in negotiating a contract award. If the government can prove the contract or subcontract price is overstated because of its reliance on the defective data both the prime contractor, and through its flowdown clauses, the subcontractor is subject to a reduction in its contract price. Even though a contract price may be the result of many factors other than defective data (e.g. negotiating skills, perceived market conditions, etc.) the presumption is, short of evidence to the contrary, the government overpaid by

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the amount of the defective data and the adjustment is equal to the amount by which the cost or pricing data was overstated. In calculating the adjustment, the government usually recognizes offsets which means that if a contractor *understates* some cost or pricing data submitted in support of its proposal then that amount can be used to offset any overstatement the government claims exists.

Defective pricing is sometimes confused with allegations of fraud. Remember, defective pricing is not a crime! Defective pricing need only require (1) cost or pricing data is defective (2) the contractor certified to the accuracy, completeness and currency of the data and (3) the government made an overpayment in reliance on the data. For fraud to exist, the contractor intends to defraud the government and/or it knew the data was inaccurate, incomplete or noncurrent. If fraud exists, the contractor may be criminally prosecuted either under the False Statement Claims Act or administratively under the Program Fraud Civil Remedies Act of 1986. Of course, a defective pricing review can evolve into a fraud case if the auditor suspects fraud and refers the case to an investigation unit of the buying agency.

Audit Steps

During an audit, the auditor will establish a baseline for all contracted cost elements (e.g. labor, materials, overhead). This baseline is usually the last proposed amount adjusted by any subsequent cost or pricing data used in negotiating a price. Next, the auditor will request the contractor supply actual incurred cost for the contract or if the contract is not complete, then incurred costs plus estimates to complete for each cost element. The auditor will compare the proposed and actual data and will then focus mainly on those cost elements where actual costs are significantly less than the proposed amounts. The auditor will attempt to determine whether these lower cost items reflect defective data by determining (1) if operations proposed were not performed or (2) costs proposed were not incurred or (3) whether items of direct cost proposed were higher than was appropriate based on information available but not disclosed. Examples of the latter are a firm quote was in hand after original proposal was submitted but before price was agreed to or a previously used supplier who was known to submit low bids and was subsequently used was not included in the proposal. Common audit steps include conducting interviews, reviewing board of director minutes, examining proposal files, comparing estimated work with actual work tasks, looking for evidence of new or improved processes that may have been known at the time of price agreement, updating historical labor hours to determine the learning curve benefits, etc.

Remember, a contract price is not defective simply because subsequent changes (e.g. market conditions, changes in make vs. buy decisions, labor availability shifts) allow a contractor to obtain lower prices.

Once the review is complete, the auditor then calculates a recommended price adjustment, computing direct costs, indirect costs and profit and also taking into account relevant offsets. For the prime contractor or upper-tier subcontractor, the adjustment will include the defective pricing findings associated with audits of subcontractors. It is critical to ask for and receive an exit conference to discuss the results of the review. In our experience, more than most audits, the audit findings are based on incomplete facts and misinterpretations affecting the findings. The exit conference and subsequent follow-up communications at the audit level provide a great opportunity to negotiate more acceptable results before positions harden later.