// GCA REPORT
(A publication of Government Contract Associates)
March - April 2006 Vol 12, No. 2

GCA REPORT

NEW DEVELOPMENTS

New Contract-Related Interest Rate Set for First Half of 2006

The Treasury Secretary has set a rate of 5.1/8% for the period January 1 through June 30, 2006. The new rate is an increase from the 4.50% rate applicable in the last six months of 2005. The Secretary of the Treasury semiannually establishes an interest rate that is then applied for several government contract-related purposes. Among other things, the rates apply to (1) what a contractor must pay the government under the "Interest" clause at FAR 52.232-17 and (2) what the government must pay a contractor on either a claim decided in its favor under the Contract Disputes Act or payment delays under the Prompt Payment Act. The rate also applies to cost of money calculations under Cost Accounting Standards 414 and 417 as well as FAR 31.205-10 and when a discount factor is used to calculate the present value of future payments (e.g. deferred compensation) (Fed. Reg. 38,952).

CAS Board Proposes Exemption of T&M, LH Commercial Item Contracts

Whereas acquisition of commercial items under firm fixed price contracts are currently exempt from the cost accounting standards, the CAS Board is proposing to expand the exemption to time and material and labor hour contracts for commercial items. Since T&M and LH contracts for commercial items must be awarded on a competitive basis and the contracting officer is precluded from obtaining cost or pricing data from bidding contractors, the Board has concluded such contracts should be exempt from CAS. It seems that the proposal follows many commentators' assertions that CAS, which governs the measurement, assignment and allocation of costs under high dollar cost-type contracts, is a deterrent from attracting commercial companies doing business with the federal government.

DOE Proposes New Public-Private Research Contracting Vehicle

The Department of Energy has issued a proposed regulation to offer a new type of research, development and demonstration (RD&D) funding – the technology investment agreement or TIA. The new type of funding will be available to all types of organizations – established companies, technology startups, universities, profit and nonprofit research institutions and state and local governments. It is intended to offer greater flexibility over normal procurement contracts and its handling of intellectual property rights and cost accounting/auditing requirements are intended to attract many organizations that were reluctant to participate in DOE programs.

TIAs are not considered procurement contracts and therefore are not subject to the FAR or Department of Energy Acquisition Regulation Supplement. Rather they are considered a form of financial assistance to be used for RD&D work. They will be awarded on a competitive basis using similar public agency announcements as are now used for research awards. The government will fund some of the project while the awardee will cost share at least 50 percent which can include contributions such as facilities, equipment and materials. TIAs are particularly appropriate for research in areas where commercial and non-profit researchers are already active. They are designed to foster development from companies reluctant to work with the government and are well suited to bring together a consortia of researchers which may include a variety of organizations.

Intellectual property. Currently, DOE intellectual property rules are more restrictive than other agencies where DOE, by default, owns inventions conceived or first reduced to practice in programs that it funds unless DOE waives title. This contrasts sharply with other agencies where the inventor/contractor owns his invention and the government receives a royalty-free license for government use. Under the proposed rule, DOE will have authority to negotiate less restrictive rules similar to other agencies or even less restrictive where, for example, the government may have less or even no licensing authority.

Cost accounting and audit. Whereas the TIA will normally require the recipient to bear at least 50 percent of the overall project cost, DOE can furnish its share under a TIA in two ways – an expenditure based agreement where DOE provides funding on a defined proportion basis of total costs expended by the contractor or a fixed-support agreement where the contractor is paid by DOE on a milestone basis. The expenditure model necessitates an audit function and access to records provision so when organizations are normally currently covered by audit authorities (e.g. DCAA, Office of Naval Research) they will continue to be while other for-profit organizations may elect to be audited by either DCAA or independent public accountants where the audit costs may be reimbursed by TIA. Though a fixed support type option may be desirable by many organizations having little or no experience with requisite government accounting and auditing requirements the interim rule limits the fixed-support TIA to circumstances when (1) the desired outcomes are "well defined, observable and verifiable" (2) resources required can be estimated well in advance and (3) the agreement does not require a percentage of recipient cost sharing (Fed. Reg. 69257).

Industry Criticizes Recent Proposed Changes to Commercial Items

Preliminary recommendations by the Acquisition Advisory Panel (AAP) addressing how to establish a fair price for commercial items would "set the clock back" according to industry representatives. The AAP, which was created by section 1423 of the Services Acquisition Act to improve government acquisition practices, looked into how to establish a fair price for items considered "commercial" where market forces had yet to establish a "fair price". For example, new commercial technology often reaches the government before the private market sets prices and terms and conditions and the "market price" may be based primarily on prior government agreements rather than private contracts. The recommendations would make such items non-commercial since private industry had not created the market price. Numerous industry groups strongly rejected the recommendation saying it improperly includes price-related considerations in defining commercial items. Rather than making it easier for the government to acquire commercial products and services, the cornerstone of many acquisition related reforms over the last ten years, the recommendations would create "additional disincentives" by (1) "subverting" the definition of commercial items (2) interjecting "the unrelated pricing reasonableness" consideration into a determination of whether an item is commercial (3) limiting situations when the government can purchase commercial products and (4) increasing a potential commercial offeror's risk of being subject to costly government audits. Industry also criticized other recommendation of the AAP related to commercial items such as the (a) attempt to standardize contract terms for contracts offering commercial items rather than relying on the vendors' proposed terms and (b) requiring the Truth in Negotiation Act to apply to noncommercial modifications of commercial items.

DOD Suspends Price Evaluation Adjustment for SDBs

Effective March 10, the Defense Department has suspended the use of the price evaluation adjustment for small disadvantaged businesses in DOD procurements. The suspension is because the DOD has exceeded its five-percent goal for contract awards to SDBs in fiscal year 2005 (Fed. Reg. 9320).

Corps of Engineers Reimburses KBR's Controversial Iraq Fuel-Supply Costs

(*Editor's Note. We thought our readers would be interested in the outcome of highly publicized assertions that Halliburton had overcharged the government.*)

The Army Corps of Engineers has reimbursed the Halliburton subsidiary Kellogg Brown and Root Services for all but $9 million of the widely reported amount of $221.9 that was questioned by the Defense Contract Audit Agency. The widely reported amounts in the media related to 10 task orders of the cost plus award fee Restore Iraqi Oil (RIO) contract that involved purchasing fuel from suppliers in Kuwait and Turkey and transporting it to Iraq. DCAA's challenged costs focused on the reasonableness of costs for importing fuel from Kuwait where though circumstances forced KBR to rush into contracts with the Kuwaiti supplier, Altanmia, KBR failed to renegotiate more reasonable prices later in spite of the fact that when the Defense Energy Support Center (DESC) later assumed the role of importing fuel it negotiated reduced prices. In addition, DCAA also challenged costs of transporting fuel from Kuwait because they were higher than the costs of transporting fuel from Turkey.

In the Corps of Engineers assessment of DCAA's assertions, it found that re-competition of contracts was not feasible because of the need to deal with the company that Kuwait had approved. It also found that DESC's contracts were not a valid baseline for evaluating KBR's costs because DESC had benefited from advance planning and long-term commitments

while KBR faced "an immediate requirement with no planning time." Finally it cost more to transport fuel from Kuwait than from Turkey because of the greater distance and "more challenging security situation." The only questioned costs that were sustained, $9 million of award fees, was because some costs should have been excluded from cost pools used to calculate fees. The Corps has stated that DCAA has not expressed any disagreement with its contrary conclusion, stating cost negotiations is really "an iterative process" where an audit questions costs, the contractor provides additional information to DCAA and the CO then negotiates a settlement. Haliburton stated it considered the government's position to be a vindication where KBR succeeded at "a time when neither government agencies nor other companies could have delivered." Rep. Henry Waxman, a leading critic of KBR's performance, said the decision was "unreasonable" and urged further investigation.

Industry Opposes Government Pressures to Increase Defective Pricing Audits of GSA Contracts

Recently, Multiple Award Schedule (MAS) contractors have noticed an increased interest by the government – primarily the GAO, General Services Administration and Congress – in expanding the number and scope of audits conducted by the GSA Office of Inspector General (IG). Examples of increased pressure are (1) the March 2005 Notice of Proposed Rulemaking that would include post-award audit provisions in MAS contracts to determine whether the preaward pricing, sales or other data a contractor submitted in connection with negotiation of its MAS contract was accurate, current and complete (2) a GAO report concluding efforts to ensure the government receives most favored customer pricing has been hampered by declines in the number of pre-award and post-award audits (3) the GSA's legal counsel Kathleen Tighe expressing approval for increases in defective audit rights stating "defective pricing auditing is alive and well" while "the contractual right to audit for it is not" and (4) Sen. Tom Coburn (R-Okla), Chairman of an influential subcommittee, stated the GSA should resume defective pricing audits.

Not, surprising industry groups overwhelmingly oppose expanding GSA's post award audit rights stating such rights are inconsistent with the Federal Acquisition Streamlining Act and commercial practices. Such audits are quite burdensome and would have an adverse impact on attracting small businesses who typically lack the financial and other resources to face these audits.

Watchdog Group Criticizes Proposed Increases of CAS Thresholds

Recent proposals to increase cost accounting standard thresholds have been criticized by an influential privately funded watchdog group called the Project on Government Oversight (POGO). The group argues that thresholds have already been increased to levels that have drastically reduced the numbers of contractors who must "consistently estimate, accumulate and report costs" under federal contracts and implementation of recent proposed threshold increases would be "bad public policy." The CAS Board said the increases would be for adjustments for inflation where full CAS coverage would increase from $50 million to $56.5 million and a trigger contract would be increased from $7.5 million to $8.5 million. POGO notes that full coverage in 1993 was $10 million and the trigger contract was $500,000 resulting in an increase of 565 percent and 1700 percent, respectively, far greater than any inflation factor. POGO concluded there is no justification for the increases on an inflationary basis and there is no justification on any cost accounting basis.

House Subcommittee Reviews SBIR Program

(*Editor's Note. We have seen a significant increase of interest in our consulting practice of firms seeking SBIR contracts. The following is typical of greater visibility of the program.*)

A House Small Business subcommittee heard testimony in November on success and impact of financing issues in the Small Business Innovation Research program. Under the SBA program key government agency representatives lauded the program citing a few examples generating commercial success stories such ceramic protective armor, a computer program that translates foreign languages, catalytic combustors that reduce pollution and precision lasers used for eye surgery. The committee queried representatives on the adverse effect of a recent ruling by the SBA that investment of private venture capital exceeding 50% of a company's funding can violate the SBA requirement that qualifying SBIR participants have at least 51 percent of the business. Most agency representatives indicated the venture-capital limit may affect their programs, especially for capital-intensive firms, but so far no significant problems had been experienced.

Created in 1982, the SBA competitive grant program has three phases designed to identify, develop and then commercially apply new technology. Phase I awards up to $100,000 to test the feasibility and merits of the technology, Phase II awards up to $750,000 over two

years to develop their projects further while in Phase III participants must attract private investment for commercial use of the innovation or obtain a follow-on contract with an agency.

DOD Mentor-Protégé Program Extended Five Years

Implementing the National Defense Authorization Act for Fiscal Year 2005, the DFARS has been extended the Department of Defense' mentor and protégé program five years through January 2009. The final rule also permits service disabled veteran-owned and HUBZone businesses to participate as protégé firms (Fed. Reg. 3414).

CASES/DECISIONS

Dividends Paid By Subchapter S Corporations are No Longer Allowable

An appeals court reversed an earlier decision that made state income tax payments on dividends paid to a sole shareholder of a subchapter S corporation an allowable cost. INS is a subchapter S corporation with one shareholder. In states that recognize the single taxation of S corporations and assess income tax only on shareholders' corporate dividends, ISN never paid state income taxes but rather the shareholder paid taxes on dividends received from INS. A lower court sided with INS when the government disallowed the state income taxes payments in its incurred cost proposal. Citing FAR 31.205-41, it held under part (a) state income taxes are allowable and under part (b) costs are not allowable for "taxes from which exemptions are available to the contractor directly" and that a tax "exemption" includes only an abatement or reduction. Since the taxes were required to be paid and were paid and the tax liability on the corporate income was not subject to abatement or reduction, the state income taxes were allowable.

When the Federal Circuit recently heard the appeal it disagreed, ruling the lower court interpreted the cost principle too narrowly. It held the language of the regulation makes it clear the term "exemption" means freedom from taxation and there is nothing that supports the interpretation of the regulation that tax abatements or reductions is "an exhaustive list of exempt taxes." In response to the assertion that taxes were required and were paid, the Circuit said allowable taxes apply to taxes paid by the contracting entity not the shareholder and since INS never paid any income taxes the regulation does not apply. Even in states where a corporation that fails to have its shareholders pay the proper state tax will be penalized that is not enough to establish the tax liability of the S corporation, concluding "INS is free from taxation on the shareholder's income derived from ISN's corporate dividend" (*Information Systems & Networks Corp. v. US, Fed. Cir. No. 04-5151*).

Single Cost Pool for HMMWVs and Hummers Violate CAS 418

AM General manufactures both High Mobility Multipurpose Wheeled Vehicles (HMMWVs) for the Army and similar vehicles sold commercially under the trade name "Hummer". AM General conducted the majority of its production for both vehicles at a single plant where the HMMWVs were assembled entirely at the plant while the Hummers were finished in another building. AM general applied a manufacturing overhead rate on its government work where all manufacturing overhead was included in a single cost pool and allocated to each unit produced, military and commercial. DCAA challenged use of the single pool and sought $23 million in excess costs allocated to the government. It asserted the use of the single pool was non-compliant with CAS 418, Allocation of Direct and Indirect Costs, asserting the cost of the additional building where commercial vehicles were manufactured represented 11 percent of the total manufacturing costs and should not be allocated to the military vehicles. The Appeals Board agreed with the government, stating the single pool was not homogeneous as required by CAS 418-40(b) in that all the significant activities in the pool do not have "the same or similar beneficial or causal relationship to cost objectives" concluding if the costs were allocated separately, the resulting allocation would be materially different.

AM General also asserted that it was not covered by CAS because the fixed price contracts for the military vehicle was awarded without submission of cost or pricing data. The ASBCA disagreed pointing out that the Army waiver of cost or pricing data invoked by AM General did not include military-unique items and hence were not exempt from CAS. Further, since CAS 201-1(b)(15) only exempts from CAS coverage firm fixed priced contracts awarded "without submission of any cost data" and because AM General did submit certified cost or pricing data for certain military-unique items, the exemption did not apply (*AM General LLC, ASBCA No. 53610*).

(Editor's Note. We intend to discuss the two cases above along with another recently decided case affecting treatment of IR&D costs in greater depth in the next issue of the GCA DIGEST)

RFP Did Not Require Security Clearances for Owner and Management

A solicitation for facilities management and information technology services required "all personnel" supporting contract work had to have secret security clearances. M&M protested the award to TDSS asserting though the proposed contract personnel had the clearances its owner or management personnel did not where the "all personnel" should apply to the contractor's owners and management. GAO denied the protest, stating there was nothing in the RFP that expressly required personnel other than those proposed to perform the contract to hold security clearances. Whereas under M&Ms proposal all functions would be performed by on-site employees which happened to include management personnel, there was nothing in the RFP that required as much (*M&M Ret. Enterprises LLC, GAO No. B-297282*).

Court Ruled NASA Infringed on Boeing Patent

(*Editor's Note. The issue of when the government has a right to use a contractor's patent is often thorny and the following case helps illuminate this area.*)

NASA sought a lighter design of the external tank of the shuttle and used a new aluminum-lithium alloy which Boeing held a patent on. In its suit to obtain compensation for NASA's alleged infringement of its patent, the government challenged the validity of the patent asserting that the patent occurred "in the course" of its earlier Air Force contract, which was for research into a related low density aluminum alloy and hence the Patent Rights Clause gave the government a license to use the alloy covered by the patent. Witnesses testified that though the patent was developed during the time of the funded R&D project, it was developed as part of Boeing's independent research and development efforts and in fact the key elements of the patent had been developed and reduced to practice before the Air Force contract began. The Court sided with Boeing stating the Patent Rights Clause did not apply to inventions discovered during the contract but only to those "conceived or first actually reduced to practice in the course of or under" the contract. Another part of the clause emphasized the government could not otherwise obtain the rights to any invention not conceived or first actually reduced to practice "in the course of or under" the contract. However, if Boeing failed to disclose an invention conceived or reduced to practice under a contract the United States would obtain not only a license to such an invention but the invention itself. The court concluded the government failed to demonstrate the conception or first actual reduction to practice of the alloy occurred "in the course or under" the Air Force contract and hence the patent was infringed upon (*Boeing Co. v US, Fed. Cl. No. 00-705(C)*.

Termination Under a Cost Share Arrangement Does Not Limit Full Cost Recovery

The Energy Department entered into a contract with Jacobs to design, construct and install a gasification improvement facility where no fee was payable and the contract required the government to reimburse Jacobs for only 80 percent of its costs. DOE subsequently terminated the contract for convenience and Jacobs submitted a termination settlement proposal seeking 100 percent of its performance costs and DOE rejected the proposal, limiting recovery to 80 percent. The Court sided with Jacobs stating if the parties had intended the termination clause to limit the contractor to 80 percent of termination costs it would have said so rather than including the requirement to pay "all costs reimbursable under the contract." The Court ruled it could not read the phrase covering "all" reimbursable costs to mean 80 percent of such costs. It concluded a contractor is not supposed to suffer as the result of a termination nor is the government to underwrite its decision to termination (*Jacobs Engineering Group Inc. v. US, Fed. Cir. No. 05-5052*).

Agency Failed to Discriminate Between Different Prior Contract Experience

The National Institutes of Health issued an RFP seeking chemical and low-level radioactive management services that stated the award would be made on a best value basis using three evaluation criteria: technical, cost/price and past performance. Offerors were required to list five contracts completed in the last two years as well as current ones similar to the RFP. NIH selected Clean Venture over the incumbent Clean Harbors and the later protested alleging the past performance evaluation was unreasonable. Specifically, it claimed the agency failed to consider past performance references and also had the evaluation been performed properly, as the incumbent contractor, it would have received a higher rating. The Comp. Gen agreed, finding that NIH's simple, numeric score for past performance failed to account for contract relevance. NIH mailed out questionaires to the five references for each bidder and received completed surveys for each firm where NIH then averaged the questionnaires' numerical rating and concluded the

difference between competitors were "minimal." The Comp. Gen. found NIH did not go beyond the information in the questionnaires but did find the awardee's prior contracts were smaller and less complex that Clean Harbor's. It also found NIH failed to properly assess Clean Harbor's incumbent status, stating it was "arguably the most relevant past performance information available" (*Clean Harbors Envtl. Servs. Inc. Comp. Gen Dec. B-292176*).

NEW/SMALL CONTRACTORS

Identifying and Reporting Cost Overruns on Cost Type Contracts

(*Editor's Note. Unanticipated increases in contractors' indirect costs rates can lead to cost overruns on cost type contracts that sometimes must be absorbed by the contractor. The following spells out steps that should be taken to avoid liability for these overruns. The last few years we have reported on cases that addressed when contractors could be excused for not timely notifying the government of potential overruns but found the cases did not provide clear guidance. We were glad to come across an article written by Joseph Hornyak of the law firm of Holland & Knight and Peter McDonald of the accounting firm RSM McGladrey (one of us worked with Peter at Coopers and Lybrand years ago) in the January 17, 2006 issue of Federal Contracts that outlines the requirements for timely notification and discusses some of the cases we have read and reported on the last few years. We have relied on their insights in preparing this article but they should not be held responsible for any inaccuracies.*)

Generally, contractors that exceed ceilings of their contracts do so at their own risk where costs incurred over the ceiling – referred to as an overrun – are not recoverable from the government and must come out of the contractor's profit. Thus contractors need to carefully manage their costs but even when this occurs, cost type contractors may experience unexpected increases in their indirect cost rates from unexpected increases in total overhead costs, decreases in the "base" or both. Absent contract caps, the government is required to pay the contractor for its actual indirect cost rate, even if the rate was grossly underestimated or the contractor did a bad job in managing its expenses. Whereas direct costs of a contract are fairly easy to predict – project planning usually identifies these costs or a project may have a constant amount of people assigned to it where "burn rates" are identified – indirect costs are more difficult to predict. The provisional (billing) rate negotiated with the government before contract award may be far from what actual costs are.

Basic Requirements

Contractors performing on federal cost reimbursement contracts are subject to two mandatory FAR clauses: the Limitation of Costs (LOC) and Limitation of Funds (LOF) clauses. Though the LOC clause applies to fully funded cost reimbursement contracts while LOF to incrementally funded cost type contracts, both have the same requirement expressed in the same wording – contractors must notify the contracting officer in writing whenever it has reason to believe that costs it expects to incur in the next 60 days, when added to all costs previously incurred, will exceed 75 percent of the estimated cost specified in the contract. As part of this 75 percent notification, the contractor must provide "a revised estimate of the total cost of performing this contract." The clauses give the contractor the right to discontinue performance once the applicable ceiling is reached unless the CO notifies the contractor in writing that the estimated cost or amount of funds allotted is being increased. If the funding is not going to be increased, the CO should terminate the contract for convenience. In practice, these options are often not realistic. From the government's side, terminating a contract is easier said than done. From the contractor's side, there will be enormous pressure to not stop work. For example, stopping work could mean laying off employees who cannot be diverted to other work, incurring significant expenses like severance, storage expenses and subcontractor claims not to mention poor morale and difficulty of rehiring in the future. Additionally, it may damage its relationship with its government customer, especially the program managers and technical personnel who are often the "real" customer.

The LOC and LOF clauses should be read in conjunction with the "Allowable Cost and Payment" clause at FAR 52.216-7 which sets forth the procedures to establish final indirect cost rates based on the cost experience and provisional billing rates used until final rates are established. This process of preparing and submitting an indirect cost rate proposal and having it audited and negotiated can take months, even years to complete. By the time indirect cost rates are established, the performance of the contract will have often ended so contractors will not know for certain what their final cost rates are which can result in an overrun of the cost ceiling on a contract making it impractical to provide a timely 75 percent notification. However, the contractor is not relieved of the obligation to provide this notification.

The relevant clauses make it imperative for the contractor to monitor its actual indirect rates relative to its billing rates during contract performance. When it appears the final actual rate may exceed the billing rate, management needs to bring the contract in line with the budget through a variety of cost cutting measures to reduce such as canceling training, reducing travel, suspending certain purchases, etc. Even if the funding or cost ceilings permit payment of actual contractor costs, the government customer will not be very happy if the contractor exceeds budget. Too many times we have seen contractors compute their cumulative costs for purposes of the 75 percent notice requirement by simply totaling all the prior invoices and adding expected costs over the next 60 days. This computation will not capture any increases in actual indirect cost rates over billing rates. Rather, contractors need to compute its cumulative costs using actual indirect rates, no matter what its billing rates were.

Recent Cases Addressing What Was Reasonably Foreseeable

Since the government will frequently attempt to not reimburse overruns by claiming the notification requirements were not met, the courts and boards have had to address the issue of when contractors can be excused for not properly notifiying the government. Under the LOC/LOF clauses the 75 percent notice is triggered when the contractor "has reason to believe" the 75 percent threshold will be reached in the next 60 days. Absolute certainty is not required since indirect cost rates are at times difficult to predict because of uncertainties affecting both the amount of overhead costs and the volume of business affecting the base. For this reason courts and appeals boards have excused contractors from strict compliance with the notice requirements when the difference between billing and final indirect cost rates was not "reasonably foreseeable" during contract performance. In these cases, the contractor was required to demonstrate it had an adequate accounting system and that it did not disregard information at its disposal. However, though contractors have frequently argued its indirect cost overrun was unforeseeable thus excusing it from complying with the LOC/LOF clauses, the vast majority of cases have ruled against contractors.

One case where the contractor was successful is in *Johnson Controls (Fed. Cl. 479)* . Here the contractor was required to obtain insurance but final settlement of insurance costs could not be determined until after contract performance. In spite of a large increase in insurance costs and the government's contention that it had been warned that insurance costs might increase substantially, the Court sided with the contractor ruling these costs were beyond the contractor's control and the insurance company's letter was no more than a "warning." Another case, *Moshman Associates (ASBCA No. 52868*) addressed an unanticipated decrease in contractor's business and hence a decrease in the denominator (or base) of costs to absorb the overhead costs. Here overhead costs skyrocketed because the contract it expected to receive was delayed until the next year. The government maintained the contractor should have foreseen the possibility the new business would not materialize and hence was required to report under the LOC clauses, but the appeals board disagreed, ruling the contractor's loss of business was not reasonably foreseeable. However in *Defense Systems Concepts (ASBCA No. 45920)* the contractor's accounting system showed actual overhead and G&A would substantially exceed its billing rates but since it had numerous proposals outstanding, it projected additional labor costs, which if successful, would lower its overhead and G&A rates. Because of this optimistic assumption Defense did not provide the 75 percent notification and when work did not materialize it overran the funding ceiling and argued it was excused from the notification because it had no reason to believe the overrun would occur. The Board ruled Defense's expectation was not "realistic," stating it should have made greater efforts to inquire into the status of its outstanding proposals and likelihood of winning them.

In *Lansdowne Steel & Iron Co. (ASBCA No. 41110*), the contractor did provide the 75 percent notification giving an estimate of additional costs to complete the project. But the estimate did not consider the effect of the termination of an unrelated government contract that resulted in an increase in its overhead rates. After admitting it did not determine the impact of the terminated contract, the board held the 75 percent notification was inadequate. The lessons of *Defense* and *Lansdown* are to not rely on overly optimistic projections or ignore adverse developments when deciding to notify the CO of a cost overrun. The authors stress that contractors should be pessimists where it is better to provide the 75 percent notice and retract it later.

In *Dames and Moore* (IBCA No. 2553) there is an infrequent victory for contractors where the contractor was forced to evacuate a large staff of employees working in Iran during their 1979 revolution. This caused overhead rates to balloon and the board ruled the overrun was unforeseeable and hence the contractor was excused from failure to give notice. The lessons of the successful cases are the contractors will need to demonstrate their

GCA REPORT
P.O. Box 1235
Alamo, CA 94507

FIRST CLASS
U.S. Postage
PAID
CONCORD, CA
PERMIT NO 249

additional costs were not foreseeable. In this regard the courts have ruled that an accounting system that fails to signal the overrun is grounds for ruling against the contractor. But in *Optimal Data Corp (IBCA No. 1695-96-93*), where a contractor's accounting system was so good that it predicted overruns under its task services even before the work was started, the board sustained its claim that the costs were not reasonably foreseeable.

So contractors need to be vigilant in monitoring their indirect cost rates and determining the effect of those rates on its cost and funding ceilings. They must comply with LOC and LOF when there is sufficient reason to suspect the indirect cost rate increases may cause an overrun. There is little legal support for contractors recovering the overruns when the contractor has not fully provided the 75 percent notification. When this occurs, the burden will fall on the contractor to prove the cost overrun could not have been reasonably foreseen.

QUESTIONS AND ANSWERS

Q. We include selling expenses in our G&A pool that relate to both domestic and foreign sales of our products. DCAA recently questioned inclusion of the costs related to foreign sales and our former contracting manager (now retired) said that used to be the rule but he isn't sure now. Can you help?

A. Your contracting manager and DCAA auditor are showing their age (I probably will to). A brief chronology of foreign selling costs would be helpful: prior to March 1979, foreign selling costs were allowable. From March 1979 to January 1986 these costs were held to be "unallowable" because they were considered to be "unallocable" to domestic government business. (To help mitigate the problem of having to allocate domestic selling experience to all contracts, including foreign ones, while not being able to allocate foreign selling costs to government work, some savvy contractors created two separate selling expense pools – domestic and foreign and allocated each to domestic and foreign business, respectively. I expect the auditor is thinking of those times.) Recognizing this unallocable-is-therefore-unallowable situation, the FAR made foreign selling costs unallowable from January 1986 to May 1991. Appreciating the fact that expanding sales (and hence the cost base) lowers government costs, the FAR was changed in May 1991 to allow for foreign selling expenses if they relate to significant effort to export products normally sold to the US government. So, if your selling costs relate to exports of products sold domestically, I would consider challenging the auditor's conclusion.

Q. Since most of our business is cost type work for the federal government, are we responsible for sales taxes on material and supplies we use.

A. Your straightforward question is full of a history of litigation. A recent article by Professor Ralph Nash in the November 2005 Nash & Cibinic Report addressed this issue. Their conclusion is that it is clear that under cost reimbursable and time and material type contracts, for direct items of costs it is the intention of the federal government to obtain title to these items and hence state and local government have no tax claim on them. As for title to overhead items and hence liability for state and local taxes on these items, the issue is far from settled. The issue is of significance to state governments where, for example, federal government title to overhead items could cost the State of Texas $250 million in revenue.

GCA DIGEST· P.O. Box 1235 · Alamo, CA 94507 · (tel) 925-362-0712 · (fax) 925-362-0806 · Email: gcaconsult@earthlink.net
Website: www.govcontractassoc.com
This publication provides general information and is not a substitute for accounting, legal, or other professional advice.
Duplication of this publication, without written permission, is prohibited.
Subscription: $150 for one year, $275 for two years.