GCA REPORT
(A publication of Government Contract Associates)

November - December 2001 Vol 7, No. 6

NEW DEVELOPMENTS

Government Issues New FAC 2001-01 Addressing Commercial Items

In efforts to help contracting officers make better determinations of when an item is commercial, a Federal Acquisition Circular (FAC) 2001-01, effective December 21, has made some revisions to the FAR definition of commercial item, clarifies when an ancillary service is a commercial item and further encourages use of commercial terms and conditions.

FAR 2.101 definition of commercial item has been revised to clarify that services ancillary to a commercial item – such as installation, maintenance, repair, training and other support services – are considered a commercial service. This will be true regardless of whether the service is provided by the same vendor or at the same time as the item as long as the service is provided to the general public under similar terms and conditions.

The definition of "commercial item" at FAR 2.101 is also revised to include the phrase "for purposes other than governmental purposes". The revised definition states that commercial items are items customarily used by the general public or by non-governmental entities for purposes other than governmental purposes that: 1) have been sold, leased or licensed to the general public or 2) have been offered for sale, lease or license to the general public.

Also, definitions of "catalog price" and "market price" have been added to help identify services that may be acquired under the commercial item section of FAR Part 12. "Catalog price" means a price included in a catalog, price list, schedule or other pricing form regularly maintained by a manufacturer or vendor and published or available for inspection by customers. These prices must be the prices at which sales are currently made or were last made to a significant number of buyers from the general public. "Market price" means current prices established in the course of ordinary trade between buyers and sellers that are free to bargain – prices that can be substantiated through competition or from sources independent of the offerors.

To encourage use of commercial terms and conditions, FAR 12.209 (Determination of Price Reasonableness) is amended to state that while COs must establish price reasonableness when pricing commercial items they also must be aware of customary commercial terms and conditions. Commercial terms and conditions take into account such factors as speed of delivery, type of warranty, limitations of sellers' liability, performance period and specific performance requirements. Previously, COs were not required to be aware of commercial terms and conditions when pricing commercial items.

Revised Contracting Procedures to Meet the "War on Terrorism"

As part of Operation "Enduring Freedom," Under Secretary of Defense for Acquisition Pete Aldridge issued a memo stating the current national emergency meets the definition of "contingency operation" that allows for a raft of emergency contracting procedures aimed at maintaining the industrial base and expediting the flow of essential supplies to support the war on terrorism. Expediting procurements of essential supplies and services is the watchword that warrants relaxation or even abandonment of otherwise sacrosanct principles of "full and open competition." For example, FAR 6.302-3(a)(2)(I) and other provisions in the DFARS state full and open competition need not be provided when one or more designated sources decide it is necessary to maintain a facility, producer, manufacturer or other supplier during a national emergency. Other departures from "business as usual" along with regulatory references to meet the emergency include (we obtained these from the October 17 issue of The Government Contractor):

1. The government can force contractors to perform defense contracts on a preferential or priority basis even if this causes them to lose money or breach their commercial contracts (FAR 11.602; DFARS 211.602).

2. Debarred or suspended contractors may still be eligible to provide services and supplies for emergencies (Federal Property Management Regulations 105-68.200).

3. Standard Form 44, "Purchase Order-Invoice-Voucher", a multipurpose purchase order form commonly used for on-the-spot, over-the-counter purchases at or below the micro-purchase threshold of $2,500 may be used for purchases over that threshold (FAR 13.306(a)(1).

4. Oral requests for proposals are authorized when delays associated with a written solicitation would hurt the government. Also, agencies need not publicize proposed contract actions (FAR 15-203(f), 5.202).

5. The government need not provide payments through electronic funds transfers (FAR 32.1103(e).

6. Prospective contractors need not register in the Central Contractor Registration database before award of a contract, basic ordering agreement or blanket purchase agreement (DFARS 204.7302(d).

7. Alternative provisions for default terminating a fixed price contract for construction or demolition (FAR 49.504, 52.249-10).

8. Agencies are authorized, but not required, to include a "no set-off" commitment in contracts awarded during an national emergency. Such commitments prevent the government from applying against payments to an assignee (e.g. a financial institution) any liability of the contractor to the government arising independently of an assigned contract (FAR 32.803(d), (e); DFARS 232.803(d).

In addition, the Defense Department is raising the threshold to use the government-wide purchase card to $200,000 per transaction for "stand-alone" purchases. Stand-alone purchases are those that include both purchase and payment and will not apply to payments for items or goods acquired through other contract vehicles. Conditions for using the purchase card are subject to the DFARS and require (1) the supplies or services must be immediately available and (2) only one delivery and one payment will be made.

Also, Principle Deputy Assistant Secretary for Acquisition and Management Darleen Druyan issued a memo authorizing considerably more flexibility in awarding new contracts and administering existing ones to meet the needs of the war on terrorism. Example cited include "liberal use of Undefinitized Contract Actions, urgent and compelling Justifications and Authorizations, options for increased quantities, accelerated delivery options, etc."

Contractors No Longer Need to Submit First Vouchers to DCAA

The Defense Contract Audit Agency issued guidance that states contractors who are approved for direct billing need no longer submit the first voucher of a new contract to DCAA for review and approval. Rather, contractors are allowed to submit the first voucher directly to the disbursing office and provide a copy of the first voucher to the cognizant DCAA office within five days of submission to the disbursing office. DCAA says the purpose of submitting the first voucher was so they would become aware of award of new contracts but now there is sufficient notification through other procedures followed by acquisition offices and contracting officers. The new guidance is touted as improving economies and efficiencies of the direct billing program and improving cash flow for contractors. DCAA auditors during their annual review of paid vouchers will be required to insure copies of the first vouchers are sent to the appropriate DCAA office and if not, are instructed to cite contractors for a billing system deficiency (MRD 01-PPD-071(R).

DOD Revises its Previous Proposal to Change its Profit Policy

The Defense Department has taken another stab at changing its 15 year old profit policy in a proposed rule issued in September that seeks to add general and administrative expenses to the base used to determine a profit objective, increase emphasis on performance risk and encourage cost efficiencies. An earlier proposal submitted in July 2000 attempted to reorient profit incentives from facilities investment to performance risk factors and cost reduction efforts without impacting the overall profit levels. Specifically, the July proposal tried to (1) add the G&A cost base used to establish the acquisition profit objectives (2) phase out and eventually eliminate facilities investment as a factor (3) offset these changes by increasing the importance of performance risk by increasing this factor by one percentage point and decreasing values for contract-type risk by a half of percentage point and (4) add a special factor of up to 4 percent of the total contract price (excluding cost of money) for cost efficiency to encourage cost reduction efforts.

Numerous comments and meetings resulted in a revised proposal in late September 2001 where the differences

with the earlier proposed rule was (1) not to completely phase out facilities investment over four years but retain 50 percent of current values for equipment as an incentive to modernize equipment and (2) to lessen the impact on performance risk and not change the value for contract type risk since there was less need to offset the reduced emphasis on facilities investment. Adding the G&A base and emphasizing cost reduction efforts are unchanged. Specifics of how to demonstrate cost reduction were added that include (1) participation in Single Process Initiatives (2) actual cost reductions on prior contracts (3) elimination or reduction of excess idle facilities (4) contractors' cost reduction initiatives such as reliance on value engineering, spare parts pricing reform and competition advocacy programs (5) process improvement (6) subcontractor cost reduction efforts and (7) incorporating commercial items and processes. The new proposal is in the Federal Register No. 48649.

DCAA Guidance on Allowability of Supplemental Reservist Payments

As a result of recent events, many members of the National Guard and Armed Forces Reserves have been or will be called up for military duty. Many firms choose to continue many fringe benefits (e.g. health insurance) and pay employees called up the difference between what their civilian and military salaries are to help mitigate the hardships of military duty. The guidance calls attention to an October 5, 2001 memorandum issued by the Under Secretary of Defense for Acquisition, Technology and Logistics that provides these types of supplemental benefits for extended military leave are to be considered allowable costs under FAR 31.205-6, Compensation for personal services (MRD 01-PAC-075(R).

New FAR Proposal on CAS Cost Impact Process is Expected

The FAR Council is preparing to issue in the next few months a second proposed rule on the cost impact process that is triggered when a contractor covered by the cost accounting standards makes a change to its disclosed cost accounting practices. The first proposed rule was issued in April 2000 but needs revision following extensive comments.

The cost impact process ensures the government does not pay increased costs when a CAS-covered contractor makes certain types of cost accounting practices changes. DOD drafted the first rule as an alternative to one issued by the CAS Board which was extensively criticized by contractors and government representatives as too long and complex. To provide relief from onerous requirements, the first proposed FAR rule did not require submission of cost impact estimates or contract price adjustments for every CAS-covered contract affected by the accounting change. Rather, it contemplated a three-step sequence of submissions by contractors and encouraged settlement at the lowest step: (1) an initial evaluation to determine materiality of the changes (2) if the cost is material, a general dollar magnitude (GDM) proposal reflecting the minimum data needed to resolve the cost impact and (3) if the GDM proposal is insufficient or inadequately supported, a detailed cost impact proposal.

Many comments, especially from the American Bar Association, said the proposed rule did not go far enough to correct deficiencies in the current regulations and the result could be to increase, not decrease, the administrative burdens. Contractor representatives have been urging the cost impact rule should (1) allow ACOs the discretion to use good business judgment to achieve an equitable result and (2) allow resolution of a cost impact using "generic data" reflecting the contractor business mix rather than individual contracts, whenever possible.

DOD Proposes to Identify When Exclusive Teaming Arrangements are Anti-competitive

(*Editor's Note. Creation of exclusive teaming arrangements are powerful tools to win awards. Lately, government reports have been expressing concerns that these arrangements can prevent competition and so the following helps allay the threat that the mere existence of such an arrangement is not to imply that a violation of antitrust rules exists.)*

In ongoing concerns that certain exclusive teaming arrangements may be limiting competition and may represent violations of antitrust laws, the Defense Department is proposing to clarify when antitrust violations may and may not exist. The proposed rule defines exclusive teaming arrangement to mean that "two or more companies agree, in writing, through understandings or by any other means to team together on a procurement and further agree not to team with any other competitors on that procurement." Evidence of violations of antitrust laws may be present only when three conditions are met: (1) one or a combination of the companies participating on the team is the sole provider of a product or service that is essential for contract performance (2) the teaming arrangement impairs competition and (3) government efforts to eliminate the teaming arrangement are unsuccessful. All three conditions must be met.

Air Force Uses Past Performance Evaluation to Encourage Use of ADR

The Air Force, as part of a big push to encourage the use of alternative dispute resolution instead of litigation, will soon begin taking into account a contractor's cooperation in resolving issues without litigation in evaluating the contractor's performance. This new incentive will be incorporated into the Air Force Contract Performance Assessment Reporting System (CPARS) Guide. The revision is considered a change to the Air Force's operating procedures not a regulatory change needing publication in the Federal Register or discussions.

As you would expect, many defense industry associations have opposed the plan calling it "unnecessarily coercive" stating it violates GAO decisions that contractors should not be penalized for exercising their legal rights. Air Force representatives have responded that the CPARS guidance is consistent with recent FAR changes encouraging use of ADR "to the maximum extent possible" and rather than penalizing contractors for exercising their rights the change is intended to "promote cooperative behavior in first identifying and then resolving" controversial issues.

8(a) and HUBZone Firms are Equal for Procurement Opportunities

Responding to concerns the SBA 8(a) program is squeezing out opportunities for HUBZOne firms, the Small Business Administration Counsel issued a memorandum letter saying the award of contracts should provide "parity" between the two programs.

Acknowledging some confusion among contracting officers who believe they must consider 8(a) program contractors before the HUBZone program, the SBA said procuring agencies should first identify qualified 8(a) and HUBZone firms and then consider which contracting vehicle is appropriate. The ultimate decision as to which program to use should involve a review of whether an agency has met its 8(a) and HUBZone goals.

This guidance is particularly timely in the light of two recent developments: (1) the Defense Department issued a final rule in the form of a Memorandum of Understanding between DOD and the SBA that permits DOD to award contracts directly to 8(a) participants rather than the longer process of awarding contracts through the SBA and (2) the Federal Procurement Data Center issued a report that not a single federal agency has met its statutory goal of awarding 1.5 percent of prime contracts to HUBZone firms. The report states agencies need to "Just Do It" to meet increasing HUBZone statutory goals of 2 percent prime contract awards by the end of FY 2001, 2.5 percent in FY 2002 and 3 percent thereafter.

BRIEFLY…

Final DOD Rules on Progress Payment Rate Increase and Threshold on Cost or Pricing Data

The Defense Federal Acquisition Regulation Supplement was changed as of October 1 to increase to 80 percent from 75 percent the customary uniform progress payment rate for large business concerns. The change will bring DOD in line with other executive agencies and will be applicable only to contract awards made on or after October 2001. Though it was widely anticipated that contracts awarded earlier could be modified the new rule does not provide for this. The rates for small businesses and small disadvantaged businesses (90 and 95 percent, respectively) remain unchanged.

A final DFARS rule, effective October 1, was also issued to reflect the increase in the cost or pricing data threshold of the FAR. FAR 15.403-4 (Requiring Cost or Pricing Data) specifies the dollar threshold at which contracting officers must obtain cost or pricing data on negotiated acquisitions and the threshold was increased from $500,000 to $550,000 last October, 2000

House Bill On New Depreciation Periods

On October 2 an influential congressman, Fred Upton (R-MI) introduced a bill that would amend the Internal Revenue Code to establish a two-year recovery period for the depreciation of computers, computer software and other technological equipment. The rule will revise the current IRS code that establishes a 36-month useful life for the depreciation of these items. If the rule passes, CAS covered contractors will still need to independently demonstrate the two year useful life applies to their firms in accordance with CAS 404.

Wynn Orders Stop of Routine Requests for Detailed Cost Data

Principle Deputy Under Secretary of Defense for Acquisition and Technology Michael Wynn October 2 told military service and defense agency procurement executives to "stop requiring contractors to submit detailed cost information as part of the billing process." It is common practice for many COs to routinely require detailed cost data for processing cost reimbursement,

time and materials and labor hour contract vouchers. The Wynn memo states the data is either not used or is inappropriately used to perform cost analysis tasks that are the responsibility of DCAA.

DOD to Help Contractors Access Their Business Unit's Past Performance Records

Since last November, contractors can access their past performance records in the Defense Department's single reporting for contractors' report cards – the Past Performance Automated Information System (PPAIS) at http://www.dodppais.navy.mil. Many defense contractors with multiple business units have had trouble recovering reports for their individual segments because the Central Contractor Registration system usually does not identify corporate parents' DUNS number. DOD's CCR Program Office in a letter by DOD Director of Acquisition Initiatives Donna Richbourg announced it has agreed to solve this problem by doing a single upload of corporate parent-child relationships into the CCR, after which the PPAIS will be changed to reflect these relationships. Alternatively, subsidiaries may enter this information directly. Instructions for adding parent company information into an active CCR file appears as an enclosure to the Richbourg letter at "http://www.acq.osd.mil/dp/newsarchive/news082101.htm."

FAR Reissue 2001 Available on Web Site

The Federal Acquisition Regulation has been reissued and is now available at http://www.arnet.gov/far. The reissue includes the Federal Acquisition Circulars (FACs) 97-1 through 97-27.

CASES/DECISIONS

Waivers Invalid When Obtained Through Duress and Side Agreements Not Honored

(Editor's Note. Most of us, in one form or another, seek "side agreements" in exchange for not exercising certain contractual rights (e.g. pressing claims). The following case provides an interesting example of what can happen if the side agreement is not honored.)

In its contract with the Defense Logistics Agency to produce food rations the government frequently disputed billing amounts where the contractor submitted a $3.4 million "draft" claim for additional costs related to delayed payments and other acts. In a separate letter the contractor offered to wave the claim in exchange for (1) contract concessions (2) a guaranteed loan to finance future contract performance and (3) assistance in obtaining a follow-on contract and other contracts. Government representatives verbally agreed to the terms and sent the letter to the DLA for approval.

Soon after the contractor signed a contract modification believing the DLA agreed to the letter terms. The next day the DLA rejected the letter stating the contract mod stood on its own and the government neither provided financing nor assisted with further awards. Five months later the parties executed another mod extending delivery schedules due to a government caused delay. The contractor signed the new mod and agreed to waiving all claims because the delay had caused it considerable financial damage.

In a second claim for damages the contractor argued the release it signed on the second mod did not bar a claim because (1) the government breached the "side agreement" outlined in the earlier letter and (2) the second mod was signed under duress (i.e. when one party creates circumstances that forces another party to involuntarily accept contract terms). The Appeals Board ruled for the contractor finding (1) the contractor would not have signed the first mod had it known of the government's denial of the "side agreement" (2) the government breached the "side agreement" by not providing financing and assistance and hence was not entitled to enforcement of the release and (3) duress had occurred because the government had improperly withheld payments until the mod was executed, making the second mod unenforceable (Freedom NY Inc., ASBCA 43965).

OK to Use Eichleay Formula When Workforce is Partially Idle

(Editor's Note. The ability to apply the Eichleay formula of computing unabsorbed overhead (e.g. computing a daily rate and applying it for each day – see GCA DIGEST Vol. 3 No. 1) on a delay claim is an established practice when the contractor's workforce is forced to be idle during the delay. Controversy occurs when the workforce is not entirely idle.)

Differing site conditions required cessation of work for a 100 day period during which the contractor performed other work when it could. Its payroll during the delay averaged 20 days where it averaged 40 days after the delay ended. The contractor's claim included $109,000 of unabsorbed overhead computed using the Eichleay formula and the government refused to pay the overhead portion asserting the contractor's labor was not on standby but could have found replacement work to absorb the overhead it was claiming.

The Court disagreed with the government, stating though the contractor's work was not totally suspended during the 100 day delay, progress was "significantly interrupted." The judge ruled the contractor had to remain on standby to restart work because of uncertainty of the delay duration making it impossible to take on replacement work. He stated the term "standby" does not require a workforce to be completely idle. In spite of the government's argument that the contractor's ability to move portions of its workforce to other projects meant they were not on standby, it was sufficient to show the contractor's work was "significantly interrupted" to collect Eichleay unabsorbed overhead (Roy McGinnis & Co., ASBCA No 49867).

FAR 15 Applies When a Simplified Acquisition is Akin to a Negotiated Buy

(Editor's Note. The following demonstrates the need for the government to disclose its evaluation factors and its rationale for best value tradeoffs even under some commercial item acquisitions and simplified procurements.)

An acquisition for a commercial item using simplified acquisition procedures (SAP) required a written proposal addressing numerous non-price evaluating factors such as past performance, quality control plans, etc. An unsuccessful bidder protested the award asserting the agency erred in not disclosing the evaluation factors to be used and demonstrating whether the awardee's technical superiority justified its higher bid price. The Army claimed agencies are not required to advise offerors of the relative weight of evaluation factors when using SAP under FAR Part 13.

The GAO sustained the protest stating though it agreed SAP did not require disclosing evaluation factors, the Army's failure to divulge them was unreasonable because the need to prepare written proposals with multiple evaluation factors was not "simplified" and made the procurement "virtually indistinguishable from the negotiated procurements" covered by FAR Part 15. Further, even commercial item acquisitions using SAP require a rationale describing the bases for tradeoffs when a written proposal is submitted (Finlen Complex Inc., GAO, B-288280).

Can't Use Total Cost Method for Claim when Cost Records are Missing

(Editor's Note. The following case reminds of us of the total cost method option of recovery on claims and the grounds for precluding its use.)

In quantifying its claim, the contractor sought a recovery of $3.2 million based on the total cost method which allows a contractor to recover the difference between its costs of performance and its bid price. The judge alluded to a long-standing reluctance to use the method because its use assumes all costs were reasonable, the bid was accurate and reasonably computed and the contractor is not responsible for increases in cost. To use the method, the court said a contractor must show (1) it is impossible or impracticable to prove actual losses (2) its bid or estimate is realistic (3) its actual costs are reasonable and (4) it was not responsible for the added expenses. The contractor could produce no relevant records, saying they were damaged by vandalism. Their absence indicated no proof of losses, no evidence of a reasonable bid, could not "remotely show what actual costs were" and no proof of lack of responsibility for increased costs could be demonstrated (Cavalier Clothes, Inc. vs. United States, Fed. Cl., No 95-713C).

Bidder Was Not Misled When it Knew Specifications Were Defective

Robbins, who had worked at an Air Force Base for 10 years, bid on a grounds maintenance contract at the base. When it realized the amount of acreage in the solicitation was wrong it notified the contracting officer who told Robins to bid on the solicitation as written. After getting the award it sought an equitable adjustment of $5 million based on the defective specifications. Citing *US vs Spearin* that ruled a contractor must show it was misled by errors in the specifications, the Court rejected Robins' claim saying there was no evidence Robins was misled by the inaccurate acreage estimates at the time it submitted its bid. If this was a situation where the contractor identified a possible error in the contract and the government led the contractor to believe there was no error recovery may be possible but the contractor's work at the base for 10 years indicated they must have known the accurate acreage (Robins Maintenance Inc. v. United States, Fed Cir., 01-5010).

NEW/SMALL CONTRACTORS

What's a Fair Profit or Fee?

(Editor's Note. Subscribers and clients frequently inquire about guidelines the government uses in evaluating proposed profit. Yes, there are guidelines and a general familiarity with them

can often protect profit earned and provide opportunities for additional profit. We recently came across an article by David Bodenheimer of the law firm Crowell & Moring LLP in the November 2001 issue of the Lyman Report that addresses these guidelines.)

In FAR 15-404-4(a)(3) there is a policy statement that we have often quoted when government buyers seek to impose the lowest possible profit on our clients: "the government and contractors should be concerned with profit as a motivator of efficient and effective contract performance. Negotiations aimed merely at reducing prices by reducing profit … are not in the government's interest…and do not provide proper motivation for optimum contract performance."

♦ **Acceptable Contract Fees**

Statutory Limits. FAR 15-404 imposes statutory restrictions on certain contracts: (1) 15 percent for cost-plus-fixed-fee contracts for research and development (2) 6 percent for architect-engineer services (this limit, of course does not apply to engineering services) and (3) 10 percent for other cost-plus-fixed fee contracts. In addition, regulations generally disallow profit from claims for delay under the Suspension of Work and Government Delay of Work clauses (FAR 52.242-14 and 17, respectively). Also, regulations provide for no-fee contracts when the contractor agrees to cost-sharing arrangements under Far 16-303..

What's a Fair Profit Rate? The question "what is a fair profit" can be as elusive as reasons for or against a given profit rate. Nonetheless, a surprising number of cases have centered on a 10 percent profit rate as the going rate for doing business with the government (*Ideker, Inc.* found 10% to be reasonable; *Kong Yong Enter Co.* found 10% to be fair and *Techno Engineering & Constr.* rejected 4% when 10% was normal). For contractors looking for higher profit rates, 15 percent has been widely accepted in cases involving contract changes and breaches (*Big Chief Drilling Co., Yamas Constr.*) though many cases for changes have provided far less profit.

What happens to fee when a cost type contract overruns the original budget? Does the ceiling amount cover only costs where fee can be collected in excess of the ceiling? It depends. Where the Limitation of Funds clause limits the government's obligation for "costs" incurred (without reference to fee) the courts have generally held that a contractor first recovers its full costs up to the ceiling (without any reduction to fee) and then collects fee over and above the ceiling (*Allied Signal, John McMullen*). Conversely, when the contract specifies that the Limitation of Funds clause includes both fee and cost, the contractor may not recover either cost or fee above the ceiling.

♦ **Profit on Changes**

The right to profit when changes increase a contractor's cost is well established. The purpose of an equitable price adjustment under the Changes clause is to "keep the contractor whole when the government modifies a contract." An essential element for this "wholeness" is allowance of a fair and reasonable profit.

The government often attempts to thwart the established principle of profit on additional cost in three ways:

1. *Profit on changed work should be limited to the profit rate in the original bid.* While the courts do consider the original profit rate, cases have generally provided for higher profit rates on contract changes than those originally proposed (*Ryan-Walsh* gave 10% when the original was 5%; *Keco Indus.* provided 5% when the original bid was no profit).

Factors found to justify higher rates than those found in the original agreement include: (a) changed work imposes greater risk and difficulty on the contractor than the original bargain (*Ryan Walsh vs. US*) (b) when changed work has increased the complexity and difficulty of performance (*Franklin W. Peters & Assocs.* justified a higher fee when design changes occurred) and (c) when a constructive change to an option resulted from an improper exercise of the option (*Safeguard Maintenance Corp.*). Conversely, when a contractor has already incurred the costs for the additional work, a lower profit rate than originally bargained has been found to be justified because the associated risk is less than with future work.

2. *When the contract is in a loss position, zero profit is appropriate*. The courts have ruled that while it is appropriate to hold a contractor to the risks it assumed for the originally contracted work, it is not proper to hold the contractor to the same risk when performing additional work and undertaking additional risk it had no reason to anticipate *Stewart & Stevenson Service, Inc., Accord, Litton Systems*).

On the other hand, when the government seeks a price adjustment for a deductive change (e.g. lower scope of work), the government will seek recovery from both overhead and profit. If the deducted work would have been performed at a loss, the courts have refused the government's demand for profit for to do so would unfairly pyramid the contractor's losses by deducting profit that would have never been earned.

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

3. *Profit should not be applied to overhead and G&A costs.* Unless profit is expressly excluded by contract provisions, the courts have generally ruled that profit is to be applied to not only direct costs but indirect costs as well.

Also, though profit on contract breaches was disallowed in a few older cases, modern cases have ruled that profit should be allowed.

♦ **Requirements of Profit Analysis**

FAR 15-404 states most agencies making noncompetitive contract awards totaling at least $50 million per year shall use a structured approach for determining the profit or fee objective when those acquisitions require a cost analysis. The Defense Department in DFARS 215-404 also provides for a structured approach for developing a pre-negotiation profit or fee objective when cost analysis is required. Exceptions are made for competitive contracts, cost-plus-award-fee contracts and federally funded R&D Centers.

QUESTIONS & ANSWERS

Q. I'm confused about whether I am supposed to add an overhead amount to the IR&D labor costs I include in my G&A pool. Could you help?

A. It depends on whether the IR&D labor is included in your overhead base. If a cost is included in your overhead base, then you are saying all costs included in the base should have a prorata share of overhead costs applied to it. If IR&D labor is included in the overhead base, then an overhead amount should follow the IR&D labor, whether it is a direct research project, an indirect IR&D project or simply transferred to the G&A pool. If IR&D costs are not included in the overhead base, then those costs do not get a prorata share of overhead costs assigned to it and hence the IR&D costs allocated to the G&A pool should not include an overhead apportionment.

Q. Our CEO has received a substantial raise but, for competitive purposes, we do not want to either bill him out or claim (about 30% of his time is direct) a higher salary rate. On our cost type contracts, can we keep the same old direct and indirect rates that reflect his old salary or do we need to increase them?

A. Yes, you may use the lower amount - we do not know of many contracting officers or auditors who will object to a contractor claiming less costs than they incurred. Assuming the amount of increase and the salary level will not be challenged on reasonableness grounds, we would recommend showing in your incurred cost proposal (or even forward pricing rates) a pool of costs that include the total costs and then insert a line item called "management concession" or "voluntary reduction" or similar title that demonstrates the amount you are voluntarily deducting from the overhead pool. The purpose of identifying the amount you are reducing rather than simply proposing a lower rate is the management concession may be used as an offset to other questioned costs. We say "may" because we have seen it work both ways – the auditor will offset questioned costs by the amount deducted while others will not, claiming the reduced rate is the proposed rate and any questioned costs are a reduction from there.

Subscription: $125 for one year, $225 for two years.