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THE BASICS OF "OTHER TRANSACTIONS"

"Other Transactions" is a new and growing vehicle for contractors to participate in government research and prototype development projects. Recent evaluations indicate it is a highly effective method to encourage the widest possible participation in furthering the government's research and development priorities and all indications are it will be used with increased frequency in the near future. The opportunity to defray expenses, accelerate research projects on firm's "To Do" list, share knowledge from other participants and gain valuable teaming experience are some of the benefits participants commonly cite. We think the majority of our readers either are or will participate in OT projects and the following is intended to provide a reasonably detailed overview of the projects and a summary of what to expect from auditors. For a description of the basics we have relied on an article in the March 1998 edition of Briefing Papers by Carl Vacketta, Richard Kuyath and Holly Svetz from the Piper & Marbury L.L.P. and our colleague Paul Masson from Paul Masson Consulting in San Francisco that specializes in forming and operating public/private technology partnerships as well as administering OT programs with the Department of Defense and NASA. For audit guidance, we have used the DCAA Contract Audit Manual as well as various Memorandum for Regional Directors.

Introduction

The government has been particularly innovative in using different contract arrangements for acquiring or supporting its research and development. The traditional vehicle was the procurement contract which is covered by procurement statutes, the Federal Acquisition Regulation and supplementary agency regulations as will as unique cost accounting and cost allowability rules. To attract the best resources including those firms who prefer not to contract with the government because of the burdensome rules, Congress authorized two other, more flexible vehicles – the *grant* used primarily to support university and nonprofit organizations and the *cooperative agreement* not subject to FAR but to detailed Office of Management and Budget Circulars that were still perceived to be burdensome. To further encourage greater participation, Congress in 1989 temporarily authorized the Defense Advanced Research Projects Agency (DARPA) to utilize another type of assistance agreement – the so-called "other transaction" (OT). The term comes from a section of NASA's enabling legislation (National Aeronautics and Space Act of 1958) which provided the agency authority to "enter into and perform such contracts, leases, cooperative agreements or *other transactions* as may be necessary in the conduct of its work …" Since the OT is not a procurement contract, grant or cooperative agreement, it is arguably not subject to any procurement laws, regulations, circulars or other rules governing these instruments. Congress has expanded OT authority so now all military departments and NASA have authority to issue these types of agreements for both research (referred to as Section "2511" after relevant sections of its original authorization act) and prototype (Section "845") projects. The OT method has been used very successfully by DOD and NASA (130 OTs issued in 1997 alone). This article will briefly discuss the types of OT, general provisions of OT agreements and recent DCAA audit guidance issued to its auditors in case they are asked to review OTs as well as our experience auditing participants of OTs.

Types of OT

OTs for research and prototype projects typically include agreements between DOD and NASA and a single entity or consortium formed for the purpose of carrying out the OT. The various types of OTs can be funded on a cost reimbursement, fixed price, time-and-material, labor-hour or payable milestone basis.

◆ Research

Under a research OT a single recipient or consortium performs basic, applied or advanced research. To the extent possible, at least 50 percent of the costs of performing the research must be contributed by the non-government parties. While the government has entered into a number of research OTs with individual contractors (e.g. Intel Corp., Cray Research, Boeing Corp.) most OTs have been with consortia composed

of two or more legal entities such as commercial firms, government contractors, federal laboratories, small businesses and educational institutions. DARPA and NASA policy excludes research OTs for the principle purpose of acquiring goods and services for the *direct* benefit or use of the government but rather focuses on furthering state-of-the-art technology for future products or services or enhancing American competitiveness in the world. Use of an OT to sponsor basic research at a university or nonprofit research entity is precluded, preferring use of the standard grant. Use of OTs are considered appropriate only when at least one for-profit concern, particularly a firm that has traditionally not conducted business with the Government is involved.

◆ Prototype

Under a Section 845 prototype OT, a project is undertaken by either a single party or consortium that is directly relevant to a weapon or weapons system acquired or developed by DOD. Such projects may also include subsystems, components, technology demonstrations, training simulations and auxiliary and support equipment. Other common prototype projects include adaptation, testing or integration of commercial items for military purposes. Unlike the research OT, the prototype OT may be used – as a precursor to production – to acquire goods and services for the direct benefit of the government and need not provide for cost sharing arrangements for purely military projects. Like the research OT, the prototype OT is exempt from the FAR and DFARS and standard socioeconomic requirements found in procurement contracts (both, however, require compliance with Title Vl of the Civil Rights Act of 1964 relating to nondiscrimination). Payments are generally provided either on a cost-reimbursement or milestone basis.

Consortium Rules

Most OTs are issued to a consortium instead of a single recipient. Before the consortium enters into an OT, the government agency will require the consortium submit "Articles of Collaboration" or an equivalent document. This agreement, which is separate from the OT agreement, will set forth relative rights and responsibilities of the members of the consortium that will perform the OT research or prototype project. There is no prescribed format for this agreement but it generally addresses how the members will relate with one another and, at a minimum, should provide: (1) the name of the consortium (2) who is authorized to negotiate on behalf of the consortium (3) who is authorized to sign the OT agreement and modifications (4) technical and business goals (5) the time period the articles are in effect (6) the management and organization structure of the consortium (e.g. who makes decisions, voting rights, etc.) (7) administrative and payment responsibilities and (8) pertinent terms and conditions such as procedures for handling proprietary information, basis to terminate the agreement, member rights in intellectual property and disputes resolution.

OT Agreement

DARPA has prepared two model research OT agreements – one for a single party and the other for a consortium. Some individual departments of DOD and NASA have also prepared their own OT agreements. All the model OT agreements are shorter and simpler than standard FAR-covered procurement contracts. The absence of normal government requirements allow the parties to negotiate under more of a "freedom of contract" mode, allowing greater use of commercial practices and terms and conditions unique to the project and its participants. The OT agreements typically cover work statements, administrative and payment methods and considerations of data, patent and intellectual property.

Cost Sharing

Research OTs are required to provide for a 50-50 cost sharing between the government and OT recipient "to the extent determined practical" while prototype OTs do not require any cost sharing. Cost sharing for the latter OTs is not prohibited and some prototype OTs do require some form of cost sharing thought usually much less than 50%. For the research OT, the 50% cost share requirement must be met by the consortium as a whole, thus enabling one or more participants to make larger cost-sharing contributions to make up for any shortfall.

Cost sharing may be satisfied by either cash or concurrent in-kind contributions. The value of past research may also be considered acceptable contribution. Cash contributions can include a wide range of resources such as: expenditures for material, equipment, direct labor, labor associated overhead and other cash outlays for OT performance. The source of cash may be in-house (e.g. retained earnings, current IR&D funds), outside resources (e.g. donations from state or local governments, venture capitalist

investments), nonfederal contracts, grant revenues or profit or fee from federal contracts. IR&D funds are considered a company's own in-house funds even though these same funds remain eligible for reimbursement as indirect costs by the government under FAR-covered contracts. The condition is that the IR&D project must be relevant to the OT project to be eligible for cost sharing. IR&D costs accumulated and reimbursed as a direct government contract are not eligible for in-kind contributions.

In-kind contributions include the reasonable fair market value of equipment, materials, intellectual property and other property used in performance of the OT's statement of work. "Fair market value" is defined to mean what a prudent business person would pay not the cost of development or manufacture of the property. *(Editor's Note. Where fair market value was impossible to quantify, we have used cost of development as a surrogate method of quantifying the in-kind contribution when reviewing a contributor's voucher.)*

The value of past research is the least preferred in-kind contribution but DARPA will accept the value of prior research when, for example, the OT recipient possesses significant technical knowledge useful for the consortium but is unable or unwilling to provide other cash or in-kind contributions.

DCAA Guidance

Though a key aspect of other transactions is to attract commercial businesses who otherwise do not do business with the federal government, the Defense Contract Audit Agency has been asked by the Department of Defense Inspector General office to provide audit guidance to its staff in the event it is asked to review costs. This guidance was issued in March 1998 in the form of a Memorandum for Regional Directors (98-PSP-042R). Though it is not quite clear what their role will be, they have developed guidance for auditing participants of other transactions. Contractors can expect either DCAA or independent firms working for a consortium (such as our firm) to selectively review participants in other transactions and to follow the guidance discussed below.

The guidance provides three objectives:

1. Contractors incurred costs follow the OT terms and reasonably compare in total to billed costs.
2. The contractor's billed costs comply with the terms of the OT.
3. The contractor has provided its cost share (e.g. contribution) amount in accordance with the OT agreement and has not direct billed this to the government.

Auditors will review primarily three key documents: Schedule of Payments, Payable Milestones and Funding Schedule. The Schedule of Payments, for milestone payments, will include a description of payable milestones, dates and the amounts government versus the contractor will contribute. The Funding Schedule identifies the consortium members and their respective cost sharing amounts. Other documents examined often includes the Quarterly Business Status Report (comparison of incurred costs by quarter with forecasted expenditures), Payable Events/Milestone Reports and Annual Program Plan Document (description of forecasted expenditures and milestone events).

The guidance recognizes that costs for OTs may be accounted for in different ways: as a contract, an IR&D project or a combination of both (i.e., government cost share accounted as a contract with the contractor share accounted for as an IR&D project). It reminds auditors to follow FAR 31.205-18(e), Independent Research and Development and Bid and Proposal Costs. It further states that these IR&D costs are allowable if the work performed would have been allowed as contractor IR&D had there been no so such cooperative agreement. If the contractor accounts for the government portion of OT costs as an IR&D project, the auditor should be on the lookout that the contractor equitably accounts for the payments (e.g. credit to the IR&D account) and verify that only allowable IR&D costs are allocated to government contracts.

Audits of Contractors Normally Doing Business With the Government

It is anticipated that other transactions are sometimes awarded to contractors already doing business with the government. It is presumed that the contractor will utilize the same accounting system used for other government contracts and this presumption should be verified. The auditor is asked to perform "necessary steps" to determine if incurred costs (i.e. direct labor, material, other direct costs, indirect rates) were accounted for using normal accounting practices. If the contractor did not use its normal government accounting practices (for example, it did not use its normal approved indirect rates), then the auditor is to conduct "limited transaction testing" such as:

1. *Direct Labor*. If the contractor utilized its normal labor cost distribution system and a recent review was performed and found adequate, no further testing of labor costs is necessary. If the normal system is used and a recent review of the labor system has not been performed or was deemed inadequate, the auditor is to judgmentally select 30 labor transactions to trace through the labor distribution system. If the normal labor distribution is not used, the contractor will be asked to identify any differences and calculate the cost impact.

2. *Direct Material/Other Direct Costs*. The auditor is to determine whether direct charges to other transactions are consistent with established practices by judgmentally selecting 10 large transactions for verification to source documents like invoices. If assets like equipment, facilities, or land were purchased and direct charged to the OT the auditor is to determine if the contractor shared in the cost of these assets in accordance with the other transaction cost sharing ratio. If established practices were not utilized, auditors will request the contractor identify any differences and calculate the cost impact, if any.

3. *Indirect Rates*. Auditors are to determine if government approved rates were applied and if not, determine the basis for the indirect rates used and calculate a general dollar magnitude estimate of the difference.

◆ Payments Based on Milestones

Rather than incurred costs, some other transaction billings are based on payable events or milestones. Since the billed costs are based on a payment schedule rather than incurred costs, the auditor is instructed to compare billed costs by milestone with incurred costs by milestone to determine if any significant differences exist. The auditor will also compare total billed costs to total incurred costs to determine if there is any significant difference. The auditor will also attempt, on a selective basis, to verify the milestone was accomplished before the associated costs were billed.

Even though the guidance discusses effort as "audits", "audit steps", etc. the efforts are really "agreed-to procedures" which are distinctly different efforts under audit standards. The audit report expressly states an "audit" was not performed and hence no audit opinion can be issued. Rather, the report states that agreed-to procedures were followed. Those procedures are enumerated (e.g. determining accounting practices applied, determining incurred costs and billed amounts) and then the findings of applying these procedures are disclosed. These disclosures then become statements that identify evaluations and questioned costs not unlike the results of an "audit".

The audit guidance does not specifically address the category of contractor who does not do business with the government, whether it be a commercial contractor with little or no government experience or a commercial facility/division of a government contractor.

FINANCIAL DATA COMPARING PROFESSIONAL SERVICES CONTRACTORS

(Editor's Note. Most firms want to know how they compare with others. Unfortunately, most useful information is proprietary and almost all surveys we encounter are limited to generally useless financial data extracted from annual reports of publicly traded companies. The exception to this rule is an annual survey published by Birnberg & Associates. In a past issue we discussed the 1998 results and since we find the results of the new survey for 1999 both different in some cases and equally useful we thought we would present some of the significant findings here. The survey is unique because it surveys actual firms of varying sizes and offers very relevant data for government contractors. Though it surveys engineering and architectural firms, we find the results closely mirrors those of most professional service organizations. This is not surprising since most labor intensive businesses, particularly in professional services, incur similar costs.)

The Birnberg & Associates survey presents a wide range of useful information: comparison of data for each year from 1978-1999, profit and loss statements, key financial ratios (e.g. current ratio, average collection periods), identification of key overhead cost elements (e.g. all fringe benefits, insurance, indirect labor, depreciation, marketing costs etc.), key measures of productivity, and other financial measures (e.g. work-in-process incurred but not billed, number of firms that charge interest on late accounts). The following table and explanations represents a selection of measurements for 1999 we chose that will provide interesting comparisons for our government contractor readers. For those who (like us) forget statistics terms, "mean" refers to an average while "median" refers to a midpoint.

		Mean	Median
1.	Net Profit Before Tax on Total Revenue Before Tax & Distributions	10.08%	10.30%
2.	Net Profit on Net Revenue Before Tax & Distribution	11.77%	12.24%
3.	Contribution Rate	62.09%	63.31%
4.	Overhead Rate (Before Distribution)	149.41	153.09
5.	Overhead Rate (After Distribution)	172.97	162.55
6.	Net Multiplier	2.93	2.80
7.	Unallowable Overhead as a Percentage of Direct Labor	15.95%	6.68%
8.	Unallowable Overhead as a Percentage of Total Overhead		
	- Before Distribution	9.50%	5.72%
	- After Distribution	8.35%	4.47%
9.	Allowable Overhead as a Percentage of Direct Labor		
	- Before Distribution	123.07	128.15
10.	Net Revenue Per Total Staff	$77,720	
11.	Net Revenue Per Technical Staff	$101,696	
12.	Chargeable Ratio	62%	
13.	Marketing as a Percent of Total Revenue	3.44%	
14.	Health Benefits as a Percent of Total Revenue	2.60%	

1. Net Profit on *Total* Revenue before Tax and Distribution. Total revenue includes revenue generated from in-house labor (representing 85-90% of total revenue) as well as consultants or subcontractors and billable reimbursable expenses. Before distribution is before bonuses and profit distribution – since these items vary widely, the survey compares results before and after such distribution.

2. Net Profit on *Net* Revenue Before Tax Distribution. Net revenue refers to revenue generated only by employees and may be more relevant for firms having unusually high outside consultants and/or large reimbursable expenses.

3. Contribution Rate (before distribution). The portion of each dollar of revenue after direct project costs (labor and expenses) available for overhead and profit.

4. Overhead Rate (before distribution). This is the percentage of total office overhead to direct labor. What the survey calls "office overhead" is really what many contractors call overhead and G&A including the portion of employees labor not direct charged to projects. Adjustments for unallowable costs are addressed below.

5. Overhead Rate (after distribution). Same as above but the overhead includes bonuses, employee profit sharing and other distributions but not distribution of profit.

6. Net Multiplier. This is the effective multiplier achieved on direct labor and is calculated by dividing net revenue by direct labor. Consultants and reimbursables are excluded in order to determine an actual multiplier achieved by the firm's own efforts. The figure indicates participating firms received $2.93 for each $1.00 of direct labor spent.

7. Unallowable Overhead as a Percentage of Direct Labor. This consists of total overhead that contractors either voluntarily delete or government auditors disallow as a percentage of direct labor.

8. Unallowable Overhead as a Percent of Total Overhead Before and After Distributions. Looking at unallowable costs from a different vantage.

9. Allowable Overhead as a Percent of Direct Labor. This is actual overhead applied to direct labor after unallowables have been removed. If your firm uses multiple overhead rates, you would have to adjust them to measure oranges and oranges.

10. Net Revenue for Total Staff. This rough productivity index measures net revenue for each employee or part-time equivalent. It is calculated by dividing net revenue by average total staff, including principles and part time equivalents.

11. Net revenue Per Technical Staff. This is probably more relevant because it measures revenue by those directly responsible for generating it.

12. Chargeable Ratio. Measures the percent of total staff time charged to projects (whether billed or not) and is calculated by dividing total direct labor by total firm labor (direct labor plus indirect labor, vacation, sick leave and holidays actually paid).

(Editor's Note. The survey can be obtained through our office by remitting $100 by check or VISA/MASTERCARD to GCA REPORT, PO Box 1235, Alamo, CA 94507. Feel free to call (925) 362-0712 or email us at gcaconsult@earthlink.net)

DCAA CRITERIA FOR AN ADEQUATE PROPOSAL

(Editor's Note. In spite of a great hoopla over commercial practices, the bulk of government dollars spent are still included in proposals that are audited by Defense Contract Audit Agency and negotiated by buying agencies. Auditors are asked to review price proposals for adequacy of cost or pricing data and are to determine whether a price proposal is "adequate", "inadequate in part" or "wholly inadequate". A determination of "wholly inadequate" is a sign to the contracting officer that price negotiations should not begin until significant adequacies are resolved. Even an opinion of "inadequate in part" can result in problems of price negotiation if the cited "inadequacies" are perceived to affect price.

We find both new and veteran contractors need a checklist of what constitutes an adequate proposal in order to minimize chances a proposal is rejected. We came across a series of articles in the Contract Pricing Advisor that discusses what auditors and negotiators consider sufficient deficiencies to reject a proposal.)

The following is intended to identify those "pricing deficiencies" in a proposal that auditors and negotiators consider sufficiently important to avoid beginning to negotiate a contract, let alone award them. We will identify and briefly discuss what they consider unacceptable and suggest what contractors can do to avoid such conclusions.

Chapter 9 of the of The Defense Contract Audit Manual (DCAM) is the guidance that DCAA auditors are asked to follow when reviewing a proposal and Chapter 9-200 is the section that auditors follow for determining the adequacy of a proposal. That section lists eleven common deficiencies that either alone or in combination are to be considered sufficiently poor for negative opinions. These eleven deficiencies are:

1. Significant amounts of unsupported costs.
2. Material differences between the proposal and supporting data resulting from the proposal being out of date or available historical data for the same or similar items not being used.
3. Large differences between detailed amounts and summary totals.
4. When materials are a significant portion of the proposal, no bill of materials or other consolidated listing of the individual material items and quantities being proposed.
5. Failure to list parts, components, assemblies or services that will be performed by subcontractors when material amounts are involved.
6. Major differences between resulting unit prices proposed being based on quantities substantially different from the quantities required.
7. Subcontract assist audit reports indicate problems with access to records, unsupported costs and indirect expense rate projections.
8. No explanation or basis for pricing inter-organizational costs.
9. No time-phased breakdown of labor hours, rates or basis of proposal for significant labor costs.
10. No indication of basis for indirect cost rates.
11. The contractor does not have budgets beyond the current year to support indirect expense rates proposed for future years.

1. *Unsupported costs*. By "unsupported" costs, the auditor means insufficient documentation to form a basis of determining if a cost is allowable. For incurred cost proposals, its pretty straightforward – a transaction is supported by a labor recording document, invoice or other documentation created at the time the transaction was recorded (e.g. journal entry). For cost estimates, "support" is more problematic because an estimated cost has not occurred. It is quite common, however, for some auditors and price analysts to hold the same standard of supporting documents as would exist for incurred costs even though an estimated cost is largely judgmental.

Nevertheless, some form of support for the cost is required. For items previously produced, detailed support should be available. If circumstances are not expected to significantly change then historical indirect cost rates would be considered reasonable support. "Engineering estimates", though considered "merely judgmental" is commonly accepted especially when the person doing the estimate has credibility.

2. *Differences between proposed costs and supporting data due to support being out of date*. If factual data is used by a contractor in its estimates, then that data should be current when the proposal is being prepared. After that time, the contractor should ensure the data used is current up to the time of price agreement. Ensuring the date is current should not be confused with the unjustified position of some auditors that a proposal needs to be updated. Numerous decisions by Boards of Contract Appeals have established that if a contractor updates its cost or pricing data but does not update its proposal per se the contractor has met its obligations.

The type and format of updated information has also been extensively litigated and is often a point of contention between auditors and contractors. For example, a contractor is not required to submit data in a requested format if it is not readily available. Or, for example, the years of historical production data needing to support an estimate has been litigated where a contractor's submission of two years worth of data was considered adequate when the government was seeking more years. What is considered sufficient can differ in each circumstance and the contractor should be prepared to justify its estimates by facts and resist unreasonable requests for more.

3. *Differences between detailed amounts and summary totals.* It is clear that if summary totals do not reconcile to detailed amounts in the proposal there can be problems. Less clear is when the data may exist somewhere (e.g. a shoebox, indecipherable spreadsheet) and is believed to "be all there" but effort is required to reconcile the amounts. If it is very time consuming or impossible to reconcile due to lack of detail a reviewer is usually justified in concluding the totals do not match the detailed amounts. In other cases where auditor's unsuccessful attempts to reconcile totals to detailed cost data not used in preparing the proposal becomes not a reconciliation issue but an instance of an auditor substituting their judgment for the contractor's judgment and a judgement of inadequacy should be resisted and discussed at negotiations.

4. *Absence of bill of materials or other consolidated listing of individual material items.* The absence of such a listing could be legitimate grounds for a determination of inadequacy when the materials are known in sufficient detail at the time of price proposal. In other cases, such as the design, development and construction of a new item, there is insufficient knowledge of what are the necessary materials and a bill of material is not realistic. Auditors, used to reviewing proposals with nice neat bill of materials may automatically reject a proposal without one so either a bill of materials should be sought or detailed reasons should be offered for why one is not possible.

5. *Failure to list parts, components, assemblies or services.* FAR Table 15-2 instructions for supporting proposals lists these items to be provided if they exist. Like the discussion under bill of materials, they should be provided if they exist and if the nature of the contract makes their provision unrealistic (e.g. design, development, construction of items) then detailed reasons for their absence should be available if asked.

6. *Differences in proposed unit prices based upon differences in required quantities.* Auditors and price analysts closely examine whether proposed unit prices reflect the quantity discounts the proposed contract would offer. They usually assume the unit prices should reflect savings as if the quantities will be purchased at one time while there may be many reasons why this is not appropriate (e.g. just-in-time inventory approach). When this is not the case, an auditor's opinion of inadequacy should be challenged and reasons for the different approach identified.

7. *Problems with record access by subcontractors.* The prime should be very familiar with FAR Part 12 exemptions (e.g. adequate price competition, catalogue or market price, commercial item, etc.) from requiring cost and pricing data to determine whether they are applicable to a subcontractor. If one of the exemptions do not apply, then a prime or upper-tier subcontractor may want to reconsider using a subcontractor for pricing purposes if auditors use the subcontractor's inability to justify its proposal on a cost basis as a problem.

8. *Pricing inter-organizational costs.* As mentioned above, the business unit preparing the proposal should be familiar with FAR Part 12 exemptions from submitting cost and pricing data from another organizational unit of the company. If one of the exemptions do not apply and cost and pricing data is required, the business unit must be able to justify its cost buildup. If this is problematic, then the proposing unit should consider another source for its proposal to avoid the possibility of an audit of the subcontractor business unit.

9. *Time phased breakdown of hours, rates or basis of proposal.* The time phased requirement means that direct labor hours should be estimated by month, quarter or year and that direct labor rates also identified by time period. Contractors should be prepared to justify escalation rates, particularly if they exceed three percent. Whenever possible, an offeror should use labor categories that are established by its own system. If the solicitation asks for different labor categories, care must be taken to ensure a reconciliation of labor categories is documented.

10. *Indirect cost rates.* An offeror should indicate how the proposed indirect cost rates are computed, what are the cost elements used and how they are applied. Rates that are different than those incurred in the previous period should be supported by budgets. Elimination of any unallowed costs should be evident. For example, the cost should be identified and then clearly eliminated rather than merely not including it.

If a solicitation requires proposing an indirect rate (e.g. fringe benefit rate) that does not correspond to the accounting practice of the contractor, the proposal should clearly show the computation as well as evidence double counting does not exist.

11. *Multiyear budgets.* Since most firms develop budgets for only one year, this is the one deficiency that we seldom see auditors taking a hard line. If different rates are proposed then they should be documented. If the proposal is unusually large and is expected to be a significant part of the business base, auditors will want to see the impact of the contract on multiple years and some projections would be required. Less formal steps than normal budgets can be used to make these projections.

WHEN INTEREST COSTS ARE RECOVERABLE

(Editor's Note. We have encountered numerous instances of auditors identifying a cost as "interest" or "tantamount to interest" and alluding to the interest cost principle, disallowing the cost. The following describes instances of when "interest costs" are not unallowable and is based on an article by Neil O'Donnell and Patricia Meagher of the law firm of Rodgers, Joseph, O'Donnell and Quinn in the October 1998 issue of the CP&A REPORT.)

"Interest" Cost Principle

Much of the common wisdom that interest is not recoverable stems from the cost principle "Interest and other financial costs" now appearing at FAR 31.205-20. The text reads as follows:

"Interest on borrowings (however represented); bond discounts; costs of financing and refinancing capital (net worth plus long-term liabilities), legal and professional fees paid in connection with preparing prospectuses, costs of preparing and issuing stock rights, and directly associated costs are unallowable except for interest assessed by State or local taxing authorities under conditions specified in 31.205-41 (Taxes)".

While the principle does restrict recovery of interest as a contract cost, the principle contains an important limitation: it prohibits the recovery of interest on borrowing, not interest recovery in general. In addition, the prohibition against interest on borrowing is offset in part by the recognition of the cost of money invested in capital covered by Cost Accounting Standards 414 and 417. Though we will not discuss these here, they provide the opportunity to recover imputed interest cost incurred as a result of contract performance in another form.

The regulatory history of the "interest" cost principle as well as recent interpretations in two cases indicate there are opportunities to recoup interest costs in contract performance.

◆ Regulatory History

In an earlier version of the Armed Services Procurement Regulations (predecessor to FAR), "interest" was unallowable whereas in later versions of the draft the words "on borrowing" was added. This change limited application of the principle to interest *on borrowing*. The scope was expanded in November 1959 to make cost allowability to not only cost type contracts but to fixed price incentive contracts as well as contracts terminated for the convenience of the government. The regulatory history of ASPR 15-205.17 makes clear the drafter intended to preclude recovery of interest costs incurred in the context of *raising capital*.

Several board of contract appeals decisions recognized that the cost principle's disallowance of interest on borrowing is based on governmental policy that contractors who choose to operate with borrowed funds should not have an advantage over those contractors that choose to finance their work through their own capital. Several cases clearly rejected attempts at recovering "interest" costs. Some actually referred to the recovery attempts as "interest" while others used different names (e.g. "assessments of extending lines of credit", "penalty charges", "interest income lost").

Certain other cases have been decided that ruled though cost of borrowing or raising capital is unallowable, other costs not associated with borrowing or raising capital is allowable even though the cost may be an interest payment. *In Navgas, Inc.* it permitted the contractor to recover interest on judgments and interest on accounts payable since they were not associated with "borrowing" within the meaning of the cost principle.

Two more recent cases have expanded the allowability of interest payments.

1. In *Lockheed Corp. v. Widnall*, the contractor was assessed additional tax and interest charges by the State of California for inadvertently not paying state taxes several years before. The majority of the board ruled the interest paid by Lockheed was within the cost principle's allowability prohibition reasoning that borrowing had occurred whether or not the underpayment was inadvertent. The minority members sided with Lockheed stating the cost was not unallowable since borrowing had not occurred. In the light of the dispute, Lockheed appealed to the Federal Circuit court, claiming the cost principle disallowed only interest on borrowing not interest in general. The Court sided with Lockheed, noting that "borrowing" is generally defined as a loan and a loan required intent. It stated the cost principle does not make all interest payments unallowable but only that interest paid to raise capital as unallowable. While a *deliberate* underpayment of taxes may be a way to raise capital, an *inadvertent* underpayment serves no such purpose.

2. In *Ingalls Shipbuilding Inc. v. Dalton*, the contractor had incorrectly not paid certain workers compensation costs and a court later ruled it was required to pay 100% of the compensation costs plus a 10% "penalty". The government indicated the 10% amount was unallowable because (1) they were in the nature of fines or penalties and thus not chargeable to a government contract under FAR31.205-15, "Fines penalties and mischarging costs" or alternatively (2) they were unallowable as interest under FAR 31.205-20. The Court rejected both claims stating (1) they did not constitute fines or penalties under the fines and penalties cost principle but were rather a private remedy to the person injured and (2) following the Lockheed decision, nothing in the payment could be regarded as an effort to raise capital or otherwise borrow money and hence the additional charge was not prohibited interest on borrowing.

KEY 1998 DECISIONS AFFECTING COST AND PRICING ISSUES

(Editor's Note. Key 1998 decisions related to cost and pricing issues have recently been reported by Marshall Doke and Neil Cannon of the law firm of Gardere & Wynne, LLP in the January 1999 issue of Briefing Papers and Robert Korroch of the US Coast Guard Office of Procurement Law in the Public Contract Law Journal. We have reported on these decisions when they were issued in the GCA REPORT or GCA DIGEST. In spite of the risk of repetition, we believe the emphasis of these cases by legal practitioners underlies their significance to our readers.)

A case confirmed that contractors cannot recover overruns on cost type contracts containing the Limitation of Cost clause (FAR 52.232-20) when the contractor reasonably knows or should know there would be an overrun. The Limitation of Costs clause (1) requires the contractor to notify the CO in writing when it has reason to believe it will incur a cost overrun (2) provides the government is not obligated to reimburse overruns unless such notice is given and (3) the contractor need not incur the costs unless the government expressly accepts the increased costs. The contractor sought recovery of an overrun by its subcontractor by arguing that the provisional indirect rates in effect at the time the contract was entered into did not become final until after DCAA conducted an audit after contract completion. The contractor claimed the overrun was not foreseeable until it received the DCAA audit. Both the ASBCA and subsequent appeals court rejected the contractor's assertion ruling that though the clause forgives a contractor's failure to provide notice if additional costs are unforeseeable, the contractor has the burden of proving unforseeability. Since the audited rates were basically the same as those on the subcontractors books, the subcontractor knew or should have known the actual indirect costs it was incurring exceeded the provisional rates (Titan Corp. v. West, 129 F.3d 1479).

A case that earlier ruled the government was required to pay a contractor $25.9 million because of actions taken by the Department of Justice based upon negligent audits by DCAA was overturned by a higher court on the grounds that DCAA was immune from the suit because of the "discretionary function" exemption to the Federal Tort Claims Act. The exemption basically prevents suing the government from harmful actions based on DCAA audit conclusions, no matter how negligent they were, because DCAA opinions are merely advisory (General Dynamics Corp. v. US, 139 F.3d 1280).

At some point a request for an equitable adjustment to a contract price is considered contract administration and most costs associated with helping resolve the matter are allowable and no interest on the amount is payable by the government. At another point, which has been the issue of numerous, changing litigations and is still not entirely clear, the REA becomes a claim in accordance with the Contract

Disputes Act and costs associated with it become unallowable under FAR 31.205-47, Cost related to legal and other proceedings, because they are associated with the prosecution of a CDA claim and the interest clock starts ticking. The following is a significant case in this continuing issue. Following a rejection from the CO of its request for an equitable adjustment for an unanticipated asbestos removal, the contractor submitted a CDA claim. When the CO criticized the claim for being hard to analyze, the contractor hired a consultant to help clarify the matter. The consultant assisted with the claims presented to the CO and the contractor submitted new claims based on the consultant's work. The Court disallowed the consultant's costs ruling they were connected with prosecution of a claim. In the aftermath of a key decision, (Reflectone, Inc. v. Dalton) that no longer required the existence of a dispute for a REA to become a claim, the court explained that the key issue of applying FAR 31.205-47 is not *timing* of the consultant's work but its *function*. In spite of the fact that the new claims were submitted after the consultants work was completed, the negotiations that occurred after the contractor's submission of its claims were part of the contractor's prosecution of the claims and hence the consultant's fees were unallowable (Plano Builders Corp., v. U.S. 40 Fed. Cl. 635).

A contractor is entitled to recover the costs of unsuccessfully defending a wrongful discharge suit. A contractor fired three employees from a cost type contract. The terminated employees alleged the contractor discharged them for refusing to participate in a fraud and a civil jury found in their favor assessing damages against the contractor. Noting that the jury verdict did not include any findings of either illegal or intended illegal actions to defraud the government, the Board held terminating employees for unsatisfactory performance or misconduct on a government contract was necessary for proper performance of that contract and the costs of defending legal actions brought by properly terminated employees are an allowable cost of performance (Northrup Worldwide Aircraft Servs., Inc. ASBCA 45216).

The Court held that a contractor could not recover from the government the costs of severance payments made to employees after a fixed price contract expired because the costs were not abnormal or mass severance payments under FAR 31.205-6(g). Because contract expiration is foreseeable and expected, absent extraordinary circumstances, an abnormal or mass severance does not exist when a contract expires and the contractor is not entitled to costs it did not originally provide for in its fixed price (ITT Federal Servs. Corp. v. Widnall, 16 FPD).

In its claim for an equitable adjustment, the contractor included profit on unabsorbed overhead (i.e. fixed overhead it could not recoup since the direct costs it usually applied its indirect cost rate to were not incurred). The government argued that profit on unabsorbed overhead was not allowable because it constitutes "anticipatory" profit on work not performed and hence amounts to an illegal cost-plus percentage contract. The appeals board rejected the government's position holding that under established principles of law, profit is allowable on equitable adjustment claims including unabsorbed overhead unless a contract expressly prohibits it (Rex Sys., Inc., ASBCA 49065).

Based upon a reconsideration of an earlier decision, an appeals board denied a contractor's claim for jobsite overhead costs but on different grounds from its prior opinion. The contractor calculated its jobsite overhead costs resulting from a contract change in two ways. First, for changes that did not extend the time of contract performance or cause an actual increase in jobsite overhead costs, the contractor claimed its jobsite overhead by applying a set percentage of the direct costs of the change. Second, for changes that extended the time of contract performance, the contractor calculated its jobsite overhead on a per diem basis. The earlier decision rejected the first method asserting reimbursement of change orders should be based on an increase in costs and the contractor failed to establish there was an actual increase in its fixed overhead costs. In its reconsideration, the board reversed its earlier rationale for rejecting the overhead claim even though it still held it to be unallowable because calculating jobsite overhead claims using two separate methods depending on whether contract performance was or was not delayed violated the requirement of FAR 31.203 to use one distribution base for allocating a given indirect cost pool (M.A. Mortenson Co., ASBCA 40750).

In a contract to repair three boilers, the contractor temporarily installed a boiler because it was running behind schedule. The boiler was owned by the contractor and was fully depreciated. An appeals board said the contractor was entitled to be compensated and left the amount to be resolved by the parties. The contractor asserted it was entitled to $4,500 per month, the amount it could have collected from someone else had the government not needed

it. The appeals court cited 31.205-11(l) that disallowed depreciation or rental costs on fully depreciated property unless a "reasonable charge" for using the property is agreed to. Since no such agreement was made the court ruled the opportunity cost was not sufficient proof of the rental charge and in the absence of further proof agreed with the government for the disallowance (Union Boiler Works, Inc. v Caldera). *(Editor's Note. Commentators have suggested contractors seek an advance agreement for a reasonable charge or rent the equipment from a third party even though the second approach is risky if the government denies the change in contract price. Other commentators have stated though they understand the refusal of the court to calculate a use charge in the absence of adequate evidence to determine a price, they decry the fact that a contractor has no remedy if the CO refuses to negotiate a use charge).*

A subcontractor's January 1986 proposal included a G&A expense rate of 45% which was not questioned by a March 1986 DCAA pre-award audit. The subcontractor regularly provided worksheets to DCAA containing actual year-to-date G&A expense rates during the year in support of numerous other audits. The subcontractor's certified incurred cost submission that was effective as of December 1986, the date agreement on price with the prime contractor was reached, identified a significantly lower G&A rate and the government sought a contract price reduction for defective pricing because of the actual lower G&A expense. Though DCAA denied it, the board ruled the auditor did see the subcontractor's accounting worksheets during the 14 audits conducted through November 1986 and hence ruled the government failed to prove the subcontractor's actual G&A expense rates were not disclosed to the government (Martin Marietta Corp., ASBCA 48223). *(Editor's Note. The authors made two interesting observations on this case. An important point that was not discussed in the opinion was that the subcontractor's disclosure of actual rates to DCAA occurred after the DCAA completed its pre-award audit. In the past, DCAA had taken the position that after completion of its pre-award audit it was no longer the CO's "designated representative" to receive cost or pricing data. This position cannot be maintained in view of the board decision. Also, the case emphasizes the importance of documenting data provided to DCAA and other government representatives. Though DCAA denied it had seen the current G&A expense rates, the subcontractor was able to provide sufficient evidence from its documentation that made it more credible.)*

OPPORTUNITIES FOR SUBCONTRACTORS TO RECOVER DIRECTLY FROM THE GOVERNMENT

(Editor's Note. There are numerous grounds for contractors to seek an increase in the price of their contract. Much of the impact of these events affect subcontractors more than contractors themselves. Subcontractors have traditionally had no recourse to obtain relief since only the prime contractor has been considered to have "privity of contract" with the government. A recent case (Contractors Engineers International Inc. v US Department of Veterans Affairs) has recognized various exceptions that permit subcontractors to challenge procurement actions when: (1) the prime contractor acts as a purchasing agent for the government (2) the government caused or controlled the rejection of a potential subcontractor (e.g. government limited subcontractor sources or specifically recommended one subcontractor) (3) the government demonstrated "bad faith or fraud" in approving a subcontractor (4) a subcontract was made "for" the government or (5) if the government is entitled to an advance decision. For relief after contract performance has begun a new method for subcontractors to seek claims from the government is recently receiving a lot of attention. A recent article by Professor Ralph Nash in the April 1999 "The Nash & Cibinic Report" discusses the new method and identifies some of the pitfalls in applying the technique.)

It would seem there should be no difference between submitting claims to the government whether a business had a prime contract or subcontract. The government believes that the cost and effort involved in giving hundreds of thousands of subcontractors direct access to the government in disputes and claims would be excessively expensive and instead opts for encouraging the prime contractor to resolve its own issues with its subcontractors. Hence the prevailing notion is that subcontractors cannot pursue a claim directly with the government because they have no "privity of contract" with the government.

This rule has been limited by having a contractor sponsor a subcontractor claim. Contractors are now permitted (not required) to bring claims in their own names on behalf of their subcontractors. Such practice is sanctioned by FAR 44.203(c). The only limitation to this technique is that if the contractor has absolutely no liability to the subcontractor in the event of recovery. Though this sponsorship technique makes it possible for subcontractors to recover when

government action has increased their costs, there are a few pitfalls.

1. The contractor must provide the following certification for all claims over $100,000: "I certify that the claim is made in good faith; that the supporting data are accurate and complete to the best of my knowledge and belief; the amount requested accurately reflects the contract adjustment for which the Contractor believes the government is liable; and that I am duly authorized to certify the claim on behalf of the contractor". For those who take their certifications seriously, contractors may not want to fully analyze a subcontractor's claim or if they have analyzed it, may have found some deficiency. The Court of Appeals in *U.S. vs Turner Construction* has made the problem easier by ruling a contractor can properly sign a certification if it believes that "there is good ground for the claim". There is still doubt, however, what a contractor must do with regard to this certification. In one case (*Transamerica Insurance Corp.*) a standard CDA certification was considered adequate when accompanied by a letter stating "we do not have access to the subcontractor's books and records and therefore cannot make a statement with respect to the amount of their claim". In another (*Alvarado Construction Inc.*) the standard CDA certification was considered inadequate when accompanied by a statement that its certification was "subject to review of the subcontractor's proposal" because it had "not as yet examined" it. The confusion in this area, the reluctance to provide an unconditional CDA certification and the lack of desire to fully analyze subcontractor claims may be a deterrence for contractors sponsoring subcontractor claims.

2. Under this sponsorship technique, there is doubt whether a subcontractor who is a small business may recover fees and expenses under the Equal Access to Justice Act. The EAJA permits small businesses to recover such fees and expenses if they have prevailed against the Government in litigation and the Government's position is not substantially justified. If the contractor is not a small business it is not entitled to EAJA recovery. If the contractor is a small business and the subcontractor is not, there could be problems to recovery. In contrast, several appeal boards have ruled that EAJA fees and expenses may be awarded when both the contractor and subcontractor are small businesses.

3. A subcontractor whose claim was sponsored by a contractor has also been denied interest under the Contract Disputes Act. In a case where a contractor sponsored both its own and its subcontractor claim and prevailed, the contractor refused to pay the subcontractor its share of interest collected (claiming it was an offset of money it thought the subcontractor owed it). When the subcontractor sued the contractor for its share of the interest, the Court ruled it was not entitled to its share of the CDA interest under the questionable reasoning the CDA provides for interest to the "contractor" and a subcontractor does not meet this definition.

The crux of the problem is that the government does not hesitate to take actions that impact the subcontractor yet can run behind the wall of privity when the subcontractor seeks to resolve the matter. The sponsorship technique seems to be about the best method of recovering fair adjustments but has many pitfalls to its use. The authors side with an increasing number of advocates to allow subcontractors to directly go after funds where the government's actions directly impact them.

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