GCA Digest

(A publication of Government Contract Associates)

Fourth Quarter 2008 Vol 11, No. 4

TERMINATIONS

(Editor's Note. We often find that contractors do not know what costs they are entitled to when their contract is terminated for convenience so they will frequently under-propose or accept far less of the amount of costs they could have recovered. Sometimes contractors may ask government personnel for advice but this is almost always a bad idea because they are usually unfamiliar with the rules and are not exactly motivated to maximize your recovery. The following article is based on the first of two articles in the February 2008 Briefing Papers by Paul Seidman and David Seidman of Seidman & Associates. This article is, itself, an update to their earlier article written 13 years ago which we have summarized in a prior issue of this newsletter. We have frequently helped clients prepare and defend termination proposals over the last 15 years where we have relied on many of the insights of this earlier article. We think this updated version will also be a classic.)

Background

FAR 2.101 defines a termination for convenience (T of C) as "the exercise of the government's right to completely or partially terminate performance of work under a contract when it is in the government's interest." The government has broad rights to cancel a contract simply because its needs change but in return for this privilege, it agrees to pay the terminated contractor its incurred costs and certain continuing costs. Unlike private sector law that allows a seller's damage to include anticipatory profit - profit a contractor would have earned on the cancelled work - anticipatory profit on government work is prohibited.

A "termination for convenience" clause is required in all government prime contracts. There are different clauses for different contract types: for example, FAR 52.249-2, for fixed price; FAR 52.249-1, fixed price (short form); 52.249-4, government services (short form); FAR 52.249-6, cost reimbursement and; FAR 52.212-4, commercial items where there is a recently contemplated addition of Alternative 1 which will apply to time-and-material and labor hour contracts for commercial items. If for some reason a clause is excluded from a prime contract, the "Christian Doctrine" provides that it is still read into the contract because regulations require it to be while the Doctrine does not apply to subcontractors.

Formula For Recovery

Traditional government contracts use a cost-based formula to calculate termination costs where termination of a fixed price contract calls for the contractor to recover (a) allowable costs incurred in the performance of work (b) a reasonable profit for work performed (c) reasonable settlement expenses and (d) certain "continuing" (post termination) costs. Though not addressed by the authors, for most fixed price contracts the contractor is entitled to contract price for non-terminated accepted items and incurred costs for the terminated items. A contractor is not entitled to recover profit on settlement expenses. Recovery of allowable costs incurred and profit under the fixed price contract is limited to the total contract price. "Total contract price" may include any equitable adjustments to which the contractor is entitled. As we shall see, if the contractor can prove the contract would have been completed at a loss, the contractor is not entitled to a profit and recovery of costs (excluding settlement costs) can be adjusted downward for the loss.

For commercial item and certain construction and A&E contracts a "modified price-based" formula applies where recovery is composed of two elements: (1) the percentage of the contract price reflecting the percentage of work performed prior to the notice of termination and (2) any charges the contractor can demonstrate resulted directly from the termination. This is considered "modified price based" because the first element is price while the second is cost.

Cost Principles

FAR Part 31 Cost Principles. The FAR provides that the cost principles in FAR 31 are to be used in determining settlement costs under traditional government contracts. T of Cs have been held to convert a fixed-price contract to a cost type for purposes of ascertaining the contractor's allowable termination costs. However, contract terminations have been held to require special treatment of costs so the FAR added a "termination costs" cost principle in conjunction with the other cost principles in FAR

31. This termination cost principle establishes the following rules:

1. *Common items* are unallowable unless the contractor submits evidence the items could not be retained at cost without sustaining a loss. Common items are items reasonably usable on the contractor's other work.

2. *Costs continuing after termination*, despite the contractor taking reasonable efforts to eliminate them, are allowable. Idle facilities and idle capacity are examples of such costs.

3. *Initial costs* that are not fully absorbed because of the termination are allowable. For example, "starting load costs" such as learning costs and training or "preparatory costs" that would all have been absorbed by all products or services envisioned in the contract cannot be fully absorbed because the termination reduced these items.

4. *Loss of useful value* of special tooling and special machinery and equipment is generally allowable to the extent they resulted from the termination. For example, the undepreciated asset value caused by the termination would be a way of calculating the lost useful value.

5. *Rental costs* under unexpired leases are allowable for a reasonable period to the extent they cannot be avoided and were necessary for contract performance.

6. Costs of *alterations of lease property* are allowable when alterations were necessary for performance.

7. *Subcontractor claims* are allowable where an appropriate share of indirect expenses may be allocated to the costs.

8. *Settlement expenses* for preparing and presenting the termination claim as well as termination and settlement of the subcontracts are allowable. These costs can include in-house personnel and outside experts such as consultants and attorneys.

Fair Compensation Principle

The authors emphasized the importance of the fair compensation principle found at FAR 49.201 in their earlier article which we have frequently alluded to in our negotiations with government representatives. The hallmark of a termination of a fixed price contract is that exact evidence of costs incurred are usually not present because fixed price contracts do not require contractors to follow contract cost accumulation practices normally required under cost type contracts. Even if strong contract cost accounting is followed, costs are rarely accumulated by allowable components provided in a termination. In recognition of this, the fair compensation principle states that costs cannot be measured exactly and prescribes business judgment be substituted for "strict accounting principles" in arriving at fair compensation.

Profit

A terminated contractor is entitled to profit on preparations made and work done by the contractor on the terminated portion of the contract. However, profit is not allowable on settlement expenses. Section 49.202 states that the following five factors be considered when negotiating a profit (1) difficulty of work (2) contractor efficiency (3) incentive and developmental contributions (4) rate of profit the contractor would have earned had the contract been completed and (5) rate of profit contemplated by the contractor at the time of award.

General Strategies

♦ Is the Cancellation a Breach of Contract?

The first step in maximizing recovery is to determine whether the cancellation is a breach of contract. If so, the contractor would normally be entitled to more because it would not be subject to recovery limitations of the T for C clause (e.g. cost principles do not apply, anticipatory profits are allowed). Example of breach of contract provided by the authors are:

1. When a prime or upper-tier subcontractor purports to terminate a subcontract without a T of C clause. As we mentioned above the Christian Doctrine means a prime contract is held to include a T of C clause even if it was not included in the prime contract while the Christian Doctrine does not apply to subcontracts so the absence of the clause would entitle the subcontractor to anticipatory profits.

2. The government's failure to order the guaranteed minimum in an IDIQ contract is a breach unless the government terminated the unordered portion of the guaranteed minimum. The government cannot avoid liability by issuing a termination after the contract performance period.

3. The government's failure to order all of its needs under a requirements contract is a breach. Since a

requirements contract obligates the government to order all of its needs from the contractor the breach would allow it to recover anticipatory profits.

4. Though less common than the three above, bad faith or abuse of discretion is a breach which requires showing an intent to harm the contractor or the government did not have the intention of honoring its obligations.

♦ Seek Fair Compensation

This principle discussed earlier has a long history of inclusion in government regulations but nonetheless, is often overlooked by contractors and the government, who must almost always be clearly reminded of its existence. If disallowance of a cost would be unfair you should claim it even if the cost is not allowable under the cost principles. For example, direct bid and proposal costs were allowed where the court stated "a contractor is not supposed to suffer as the result of a termination for convenience nor to underwrite the government's decision to terminate." You should include a narrative on any form used stating why any cost that may be disallowed under a cost principle is necessary to provide fair compensation.

♦ Avoid Second Guessing by the Government

It is quite common for government auditors and price analysts to disallow certain costs because the work should have allegedly been performed in a different manner. For example, they may question subcontractor, lease arrangements and personnel decisions. FAR 49.113 and 49.201(a) indicate the government may not substitute its judgment for that of the contractor to disallow costs. The determining question is whether the cost is reasonable, not whether the auditor or CO would have incurred it.

♦ Reject Impractical Proof Requirements

Unlike a cost or even T&M contract, a fixed price contract is not required to document its costs of performance. Nonetheless the government often attempts to avoid paying termination costs because that fixed price contractor does not have the documentation required under a cost reimbursable contract. A liberal approach to proof of costs is required (FAR 49.201(a), *Algonac Mfg. Co. ASBCA 10534*) and use of estimates is sufficient when accounting records are unavailable due to no fault of the contractor though the contractor does have the burden to determine its estimates have a reasonable basis in fact (*Tigarelli Bros. Const. Co, ASBCA 34793*). Another case held that the contractor has the burden to prove its proposed costs "with sufficient certainty so that the determination of the amount will be more than mere speculation." A contractor's burden of proof is higher on settlement expenses and other costs incurred after termination because it then knows it is entitled to costs incurred and has a duty to keep appropriate records. The authors state you should not allow the government to impose impractical proof requirements after it terminates a contract – as long as you incurred the costs and provide a reasonable factual basis to substantiate the amount, disallowance for lack of proof would be improper.

♦ Claim All Allowable Costs

Sometimes proposed costs are rejected because the government claims the contractor is not entitled to an equitable adjustment. Unlike an equitable adjustment, where the contractor must show the government caused the cost to increase (e.g. delay, acceleration) a T of C entitles the contractor to recover all of its costs up to the contract price no matter who is responsible for the costs.

♦ Charge Indirect Costs Directly

A termination often leaves the contractor in a position where if it uses its normal way of recovering indirect costs (applying an indirect rate to direct costs) it will not result in a fair compensation because the direct costs are not incurred. When this occurs, indirect costs may be charged as direct costs following the fair compensation principle. Numerous appeals boards have continuously permitted costs normally charged indirect to be charged directly for purposes of a termination. Of course, contractors must be careful to avoid double counting by removing these costs from indirect cost pools.

Some auditors and contractors have raised the issue that charging these normally indirect costs directly violates FAR and CAS 402 requirements to treat like costs incurred under like circumstances consistently. However, several court decisions have ruled that a terminated contract is not considered to be incurred "in like circumstances" (*AT&T Techs, Inc. v US, 18Ct 315*).

♦ Avoid Loss Adjustments

If a contract is performed at a loss (i.e. it would have been completed at an amount in excess of the contract price), the contractor is not entitled to profit and termination costs are subject to a downward adjustment for the percentage of loss. The authors point out several ways to avoid assertions of loss: (1) submitting an equitable adjustment claim that will increase the price of the contract and hence avoid the loss (2) avoid submission of information that auditors can use to infer a loss (e.g. estimate-to-complete for the terminated portion of the contract, verbal assent to a loss, etc.) or admissions of a loss since the burden of proving a loss falls on the government or (3) document how numerous changes caused primarily by the government created the loss.

♦ Request Partial Payment

Though we have rarely been successful in receiving significant partial payments, especially where we have attempted to maximize recovery, FAR 49-112 does provide for partial payments on termination settlement proposals before settlement. The request for partial payment may be submitted with or after submission of the termination proposal. Partial payments that can be received are, in the aggregate (1) 100% of the contract price adjusted for items completed before the termination date or to be completed after the termination date with the CO's approval (2) 100% of subcontractor settlements approved by the CO (3) 90% of direct costs of termination inventory including materials, purchased parts and supplies and direct labor (4) 90% of other allowable costs not included above such as settlement costs and (5) 100% of partial payments made to subcontractors. The FAR states the government must "promptly" process partial payment requests. Though the expectation of receiving partial payments should not be too high, they should always be requested since not only do they help with cash flow but also helps avoid the incentive to accept an unreasonably low government offer.

♦ Do Not Agree to Perform Work at No Cost

The FAR suggests COs consider including a provision in a settlement to preserve the government's rights in defects, warranties, guarantees and other obligations for the terminated work. Contractors should either avoid any post termination obligations or not agree to continuing obligations other than those in the T of C clause without adequate compensation.

♦ Request for an Equitable Adjustment for Non-Terminated Work

In spite of boilerplate language alluding to a complete termination, it is quite common for a termination to be partial in which case the contractor is entitled to an equitable adjustment for its increased costs for performing the continuing work. It is important to understand the difference because there is usually greater recovery for obtaining the equitable adjustment. Note the time requirements for the EA is 90 days as opposed to the one year for a termination.

♦ Submit a Timely Proposal

A prime contractor in a traditional contract must submit its final termination settlement proposal to the government within one year of the effective date of the termination. The effective date is the date on which the notice requires the contractor to stop performance unless the notice is received after the stop work date in which case it becomes the date received. If a Board or Court converts a termination for default into a T of C, then it is the date the contractor receives the Board's decision. The deadline for a subcontractor to submit its proposal to the prime or higher tier sub is set forth in the subcontract. Commonly that period is six months which is less than the one year available to the prime.

The period for submitting a proposal can be extended by the Termination Contracting Officer (TCO), prime or upper-tier sub but the request must be in writing before the deadline. Courts have provided some flexibility, particularly with EAs and costs related to terminated contracts but still the request in writing should be followed. Deadlines should be met even if the proposal needs to be revised at a later date. If the deadline is not met, the contractor forfeits its right to judicial review – this allows the CO to pay whatever it wants and the contractor has no remedy. The T of C clause for a commercial contract does not set a time limit.

♦ Obtain Professional Help

T of Cs are full of arcane accounting and legal problems while creative approaches can often yield considerable benefits so contractors should obtain professional help. The good news is that costs of professional help should not be a barrier because these costs are considered to be recoverable settlement costs, even when a contractor has no other termination costs to claim other than the fees for professional advice. We have prepared over one hundred termination proposals for clients and never had our fees questioned so contractors should not hesitate to use qualified professionals when they receive a notice of termination.

ADOPTING SOUND BUSINESS DECISIONS IN THIS ECONOMY - IMPLICATIONS FOR CONTRACTORS

(Editor's Note. Though most of our readings relate to the specialized area of cost, pricing and contracting rules affecting government contractors we also like to keep abreast of general business thinking. Along those lines one of our favorite newsletters we subscribe to is The McKinsey Quarterly, the journal of the notable general management consulting firm McKinsey & Co. where we occasionally address how adoption of sound management practices specifically affect those companies who must comply with government accounting rules. Some of the recent articles, understandably address what companies should be doing in the current financial crisis and economic downturn, which are interesting in their own right, so we thought we would summarize two articles from the perspective of how implementation of their suggestions would affect costing and contracting practices of government contractors.)

Getting prices right in an economic downturn is always a challenge as decreased demand, excess capacity, and greater attention to price conspires to drive down prices. However, in the current environment not only is demand weaker making it harder to maintain prices but significantly more volatile input costs put companies in the middle. What is a business to do? They have to manage profitability of individual customers and transactions more precisely, develop greater insights into their customers' changing needs and price sensitivities and understand the types of economic factors affecting their own industries as well as their suppliers.

The authors have put forth five tactics aimed at maintaining the best balance possible between sales volume and profit margins. What are these tactics and how do they affect contractors who must compete in the government realm with price and costing rules galore?

1. *Watch for sudden shifts in price structure.* Companies need to be vigilant in monitoring pricing policies that reduce revenue such as volume discounts, rebates and cash discounts as well as costs to service customers such as freight and sales support expenses. In the current downturn, uncertain costs and declining demand can cause these elements to change dramatically. For example, volatile fuel costs put pressure on delivery costs or declining orders may mean customers are receiving volume discounts they are no longer entitled to. Techniques such as pocket margin waterfalls (i.e. identifying revenue received and subtracting all the deductions from discounts, freight, etc.) should be used that show how much revenue companies keep from their transactions where then companies can adjust their pricing accordingly e.g. adding a fuel surcharge to every order.

Implications. This waterfall analysis would be helpful to analyze government contracts so that when solicitations for new work are issued new terms may be proposed. Favorable terms granted in times where orders were higher may no longer be sustainable. For example delivery scheduling or discount terms may need to be changed. You may want to resist pricing certain items where there is significant price and cost volatility or conversely, aggressively price items where there is less volatility. Also, in this environment where commodity prices can vary widely, you will want to try and negotiate reopener clauses on fixed price contracts.

2. *Monitor customer-level profitability.* Companies should use transaction-level data to measure the profitability of each customer. By doing so, companies can detect the cost to serve particular customers where, for example, declining order volumes are pushing those customers below desirable profit levels. In most downturns, including this one, many customer groups are becoming simultaneously smaller and more costly to serve. For example, one company found that 20 percent of its customers had fallen below desirable profitability levels forcing it to either raise prices selectively and where possible, lower service costs by decreasing delivery frequency, reducing sales support or fulfilling orders through alternative channels.

Implications. Government contracts and subcontracts, contract line items, and task and delivery orders should be scrutinized for profitability. There is little wonder why we are seeing an increased use of such management tools as activity based costing to more closely analyze the cost drivers that produce expenses to better measure profitability of customers, product/service lines and contracted work. Need to monitor and change overhead rate levels (e.g. decreased facilities utilization, increased contract administration effort) need to be considered more carefully in this environment. The government provides a unique opportunity to adjust terms and prices because prices are often based on cost buildup analyses rather than what the market will bear. As more precision in monitoring profitability occurs you may find the need to either offer less or change the price of certain items offered in the past. Or, if the cost of favorable provisions are included in indirect cost pools you may want to negotiate their reimbursement as direct costs instead.

3. *Adjust to changing customer needs.* Downturns commonly create changes in customer needs and in the benefits they value when choosing a supplier. The best companies are constantly assessing, through market research and careful listening through daily contacts how economics is changing for their customers so they can react quickly by adjusting prices and benefits accordingly. For example, a resins supplier who had developed a fast curing resin to expedite flow through speed when the economy was strong now developed a less costly resin that cures slower which helps suppliers decrease their costs when product flowtime is less critical under lower demand. While other suppliers are raising prices many customers see the cost advantage of the slower curing resin. As a result, the suppler is able to maintain its profit margins while selling an alterative resin at a lower price.

Implications. When more and more customers seek government business to make up for sagging revenues they will often offer lower prices to fill up their excess capacity. Careful assessments of government needs will be more important than ever where in this period of intense price pressure there will be a premium on the ability to lower cost processes or offer lower tech employee resources that will provide government customers adequate quality for their needs at a lower cost. Careful attention to both customer needs and potential competitors' technologies are critical. Adjusting overhead rates and creative "low-ball" bidding become more important.

4. *Monitor your industry's microeconomics.* Radical shifts in costs and demand throw previous market pricing mechanisms into chaos where responding carefully requires a keen understanding of the microeconomic forces at play. For example, a building supply company saw demand plummet with the housing market yet saw costs increase rapidly and had to make a reassessment of his supply, demand and cost dynamics. His analysis led to the conclusion to cut capacity at a plant in an area where decreased supply would not cause a local shortage but lower capacity would mean less price decreases in the area.

Implications. Adjustments of these types will definitely affect overhead rates. For example, capacity (e.g. personnel, facilities, computers) may be reduced and government contractors will need to decide how to treat the resulting excess capacity. If a proposed contract is highly price sensitive these types of costs can be voluntarily deleted from overhead rates while for less price sensitive prices they can remain.

5. *Study your suppliers.* The volatility in this market requires companies to not only examine the economic factors in their industry but also for their suppliers. For example, a specialty metals firm analyzed the supply, demand and cost factors for one of its main suppliers and after doing so, predicted an industry-wide 15 percent price increase three months before it occurred. Suspecting an unusually high price increase, the company added clauses covering the supplier's cost increases to its customer contracts, a move that would have been resisted had the price increase been announced. As a result, the move established an industry precedent for passing cost increases through to its customers.

Implications. Under these circumstances the government may become receptive to reopener clauses especially when the likelihood of a substantial price increase is low. There will be the need to line up lower cost subcontractors. Also, contractors will need to bone up on recent FAR changes to how subcontract labor may be charged on prime contracts (e.g. prime contract rates, blended rates, flow-through costs).

Another McKinsey article, "How to Win in a Financial Crisis," explores opportunities available to savvy companies during a crisis to make strategic gains. Most of the gains discussed revolve around making strategic acquisitions to gain market share, teaming with other companies and making creative financing arrangements. For example, though conventional wisdom suggests that companies should put new investments or potential M&A on hold, experience of highly successful firms during periods of crisis demonstrate the opposite. The authors define three boundaries – regulation, competition and organizational ability to change - that under normal times work toward limiting opportunities but in times of crises shift dramatically to provide enormous opportunities.

Regulations move. Under normal times regulatory restraints are deeply embedded in the core assumptions of most companies where it is taken for granted that the types of businesses or markets they can enter, types of products and services they can sell and how much market share is possible is set.

However, these constraints are often released or removed during a crisis where mergers or teaming arrangement tending to concentrate businesses are encouraged where once they were prohibited. In addition, regulatory price or profit restraints are reduced to encourage the concentration of industry that was previously discouraged. We have written frequently on considerations and costing issues related to teaming arrangements and acquisitions so we suggest using our word search function to review.

Competition shifts. Times like these (e.g. interest payment defaults, loss of confidence by investors and creditors, supply chain interruptions) can quickly topple established company leaders and open the door to newcomers. Alternatively, small local players hit hard by a crisis may be acquired by larger companies which may tend to be foreign or have more diverse operations. Also creative buyout terms can be used to reduce risk – e.g. buyout payments are conditioned on achieving a set of triggers. Allowability (FAR 31.205-10, 11, 16. 17, 20, 26, 27, 33, 47, 49 and 52), allocation (CAS 403) and FAR legal issues (contract novations, foreign ownership, etc) need to be reviewed to have a good foundation in how numerous corporate changes affect government contracting.

Organization change. Resistance to bold moves in changing corporate culture and operations melt away during crises where shareholders, employees and creditors recognize things must change. Visionary leaders take this opportunity to revamp their company's power and organization structure, adjust size and generally throw out sacred cows. New organizational changes, compensation and performance bonus plans are created, moves to "best practices" and more precise costing analyses, as mentioned above, become critical to assessing profitability of specific service or product lines as well as contracts. These actions will definitely affect government audit areas including shifts in compensation and changes in bonus plans (FAR 31.205-6) and new organizational changes that may be either internal or external requiring different costing schemes (GCA DIGEST 4Q07). Also more precise costing methods may be adopted which may affect contractor cost and pricing practices which needs to be coordinated with government auditors.

A PRIMER ON PROTESTS

(Editor's Note. Despite the fact that the FAR clearly provides for the opportunity to challenge an award decision many contractors are hesitant to do so. After all, contractors are in the business to win contracts not file protests and so why, they ask, does it make sense to sue their best customer – the federal government. Whether or not to pursue a protest is an important decision. We have come across a good article by Keith Szeliga of Sheppard Mullin Richter & Hamilton LLP in the November 2008 issue of Contract Management so we thought we would visit the issue. We have complemented the article with our own comments stemming from our long experience as employees of firms who had to make similar decisions as well as consultants where clients have asked us for our opinions.)

What do you do if you believe the award decision against you is wrong? You have the option of airing your grievances within the agency by going to the contracting officer and even their superiors. In addition you can protest an award decision to either the General Accountability Office (GAO) or the Court of Federal Claims. If you choose to protest, the GAO will usually be your best choice because you will be given an automatic stay of performance (no work until the GAO resolves the matter) if you file on time while the Court alternative does not, it has more experience with protests and is usually less expensive.

Debriefing

Before making a decision on whether to protest you should schedule a debriefing. As soon as you receive a notice of not being selected or being eliminated from the competitive range you should send a written request for a debriefing to the CO. If you wait more than three days to send this request the agency will not be required to conduct a debriefing. You may receive a choice of days for your debriefing but it is important to pick the soonest date because to obtain the automatic stay you must file your protest within five days of the first date offered for the debriefing. The stay is particularly important if you are the incumbent since it is likely the agency will allow you to continue performance and thus get paid until the protest is over.

Your goal at the debriefing is to learn as much as possible why your proposal was downgraded, whether your proposal was evaluated in a manner that was consistent with the solicitation and on what basis the agency chose your competitor. Prior to your debriefing you should compile a list of questions to focus on these areas. Its also good to prepare some open-ended questions related to how the agency evaluated your proposal – extended explanations often yield important insights to raise later. Though a point-by-point comparison with other proposals are not permitted, most agencies will at least disclose the awardeee's ranking under each evaluation factor, the awardee's total price and the factors that led to the award decision. The debriefing meeting is not the time to criticize the government and put them on the defensive – rather it should be used to elicit as much information as possible to either decide to go further and to identify protestable points to be used later.

We are often asked who should prepare for the briefing meeting and who should attend. The proposal team should be heavily involved in each. For preparation purposes, counsel should be involved to identify areas to probe and what factors would best lead to a positive outcome. Though controversial, we generally believe that lawyers and consultants should not attend the actual debriefing because their presence tends to inhibit the government, making them less forthcoming and often defensive.

Timing

Protests alleging improprieties in the solicitation must be filed before bid opening or the time set for receipt of initial proposals if the improprieties were apparent prior to that time. In all other cases protests must be filed no later than 10 calendar days after the protester knew or should have known the basis of the protest, whichever is earlier. Exceptions to this is when there are debriefings. The rule here is you must file a protest within five days of the first offered debriefing date to receive the stay but you can still file the protest within 10 days of the first date offered but you will not get the stay. A senior agency official may suspend the stay if there are compelling reasons.

To Protest or Not To Protest

After the debriefing you have five days (10 if you don't mind giving up the stay) to decide and implement the decision to protest. Several considerations should be made:

1. *Was the Procurement Legally Flawed?* The first step is to analyze whether there were legal improprieties in the award decision. The fact you disagreed with the agency's judgment is not enough but rather you need to show there was something objectively wrong with the agency's evaluation. Protests are usually not effective when subjective issues are raised where the agency contracting and source selection officials had significant discretionary judgment in making its determinations. Rather, focusing on the so-called "hard," non-discretionary issues are your best chance of success where it can be shown that procurement regulations or terms of the solicitation were violated. Examples include: Were capabilities not disclosed in the solicitation evaluated? Were there any downgrades based on inaccurate information or incorrect assumptions about your proposal? Did the agency disclose all significant weaknesses, deficiencies and adverse past performance information during discussions? Was your cost/price evaluations based on the technical solution proposed? Did the agency ignore your competitor's failure to meet a minimum required solicitation requirement? Did the agency fail to consider whether your competitor had an organizational conflict of interest? Did the agency consider all the disclosed evaluation factors and only those factors when conducting a best value tradeoff analysis? Did the agency fail to adequately document its award determinations?

2. *Were you prejudiced?* Once you have determined there are good grounds to pursue a protest the next step is to determine whether you were prejudiced by the poor evaluation. To win a protest you must show the agency's errors deprived you of a reasonable chance to win the contract. Not all errors will affect a procurement so you have to be able to say if the agency had not made those errors then would you have had a substantial chance for award. If the award would have gone to someone else then there is no reason to pursue the challenge.

3. *Is there a good business reason to file a protest?* Assuming the first two conditions are met then you have to put on your business hat and ask some questions: How important is the contract to our firm? In addition to obvious sales and profitability questions does the contract allow you access to new markets, offer follow-on opportunities or allow you to maintain a desirable line of business?

4. *Will a protest adversely affect your relationship with a customer?* It should be realized that unlike the commercial world, the government expects protests especially on high dollar, contested procurements so common fears of offending an important customer are usually exaggerated. Nonetheless, as a practical matter there may be some adverse customer impact so you should consider the strength of your relationship, does the customer rely only on you for its products and services, what is the personality of the customer's representatives and how much time may pass before your next opportunity with the customer.

5. What are the chances of success after the protest? The published rate for GAO sustain rates is 27% in 2007. In our experience that figure is low because it does not take into account mutually agreed to accommodations made at the agency level that results in withdrawing a protest. Those actions raise another 10-20 points of success on initial protest filings.

6. What are the chances of winning the contract? Winning the protest does not guarantee winning the contract. The most common remedy is to reevaluate proposals or to solicit revised proposals so all you may have is "another bite of the apple." If after the debriefing you believe your proposal is highly competitive and can be revised to be even more so then the second bite may be advantageous. But if the agency seems unlikely to award you the contract under any circumstances then a successful protest may be an empty victory.

7. How much will the protest cost. It depends on the size and complexity of the procurement, the volume of the evaluation record, the need for experts and how the hearing officer manages the protest. The author, a lawyer, states the cost of drafting an initial protest is low and you can always cut your loses early if the evaluation record does not support your original position.

Filing the Protest

Get your attorney up to speed. Unless you brought in counsel earlier in the process you will first need to immediately schedule a meeting or teleconference to have the proposal team get your attorney up to speed. If the team becomes aware of any possible basis for protesting at the debriefing, that needs to be communicated to the attorney. Authorize your attorney to begin preparing the protest right away and make sure the proposal team reviews and comments on the draft since they are most familiar with the proposals and technical issues.

Protective order. In order to obtain access to the competitor's proposal and the evaluation record – essential elements to prove your case – your attorney needs to sign a "protective order" that, in order to prevent you obtaining an unfair competitive advantage in the future, precludes him/her from sharing the information with you. Since you cannot review the evaluation record or the agency and your attorney's responses you will need to rely on your attorney's judgment regarding your chances of success. The protective order both prevents your access to sensitive information but also prevents the awardee from having access to your information should it intervene in a protest to protect its interests.

The protest process. If the agency does not take corrective action to fix the errors raised in the protest the CO has 30 days to provide your attorney an agency report which consists of the CO's statements of facts, a legal memo and the evaluation record. Your attorney then has 10 days to review the agency report, respond to it and file a supplemental protest based on any new information gleamed from the evaluation record. This process and beyond is where the legal fees start to pile up so it is best to schedule a meeting with the attorney after reviewing the evaluation record but before preparing any responses. Since protests are largely won or lost based on the evaluation record you should discuss your chances of success right after the attorney reviews the record. If it is low, you will either want to withdraw the protest to cut your losses or if the stakes are high, you may want to continue even if the chances are low as long as your grounds for protest are sufficiently strong as not to ruin your credibility with your customer. If you continue the attorney will draft responses and supplemental protests after which each side often responds to each other and sometimes provides additional briefings. You should maintain continuous communications during this to make sure you are spending your money wisely.

The hearing. Most protests (90%) are resolved by the GAO based on the evaluation record. If there are disputed facts or the procurement is large and complex the GAO may hold an evidentiary hearing. At that hearing the agency's witnesses will explain the agency's evaluation and award decision and your attorney will have the opportunity to cross examine them. If you have technical or cost experts they will testify then. Because of the protective order, you will not be able to attend the hearing. Shortly after the hearing the GAO will request briefs from each party after which they will have an opportunity to respond.

GAO's decision. The GAO must decide a protest 100 calendar days after the date on which it was filed. The GAO never misses this date so there is at least an end in site. The GAO's decision will take the form of a recommendation in which the agency always follows. If you win, several forms of relief are available. If the defect was based exclusively on proposal evaluations, the GAO may limit its recommendation to re-evaluate all proposals already submitted. Or, the GAO may recommend broader relief such as reopening discussions, soliciting revised proposals and making a new source selection decision, If the GAO decides no other remedy is available it may recommend the agency reimburse you for your bid and proposal costs or in addition, it may recommend the agency reimburse the cost, including attorney fees, of filing and pursuing your successful protest. Keep in mind that unless you are a small business, the so-called "reasonable" attorney hourly fees will rarely cover actual legal fees.

Additional options. If you lose the protest, you have three options: (1) accept defeat and move on (2) ask the GAO to reconsider or (3) appeal to the Court of Federal Claims. The first option is usually the most sensible since reconsideration and appeals are usually unsuccessful. However, there are a number of recent cases that have been reversed by the Court so if there is enough at stake and you are convinced of your position and have the stomach for more expenses then the third option may be warranted.

Knowing your cost principles and cost accounting standards...

DISTINGUISHING DIRECT FROM INDIRECT COSTS

(*Editor's Notes. Whether it be pricing new government work, undergoing audits of your accounting system, establishing your own contract accounting practices or preparing a Disclosure Statement decisions on what costs are direct versus direct represent the fundamental first step. We came across a good article in the May 2008 issue of the CP&A Report by Darrell Oyer that inspired this article and we use both its insights and our experience as consultants and DCAA auditors here.)*

The first step in establishing a firm's accounting system for accumulating costs on government contracts is to determine what costs will be treated as direct and which costs are indirect. After that decision is made then contractors will decide its indirect rate structure (number of indirect rates and what costs will be included in the pool and bases of each rate). The importance of the decision can be critical: (1) the FAR and CAS address the issue requiring compliance (2) direct costs are billable, dollar for dollar, to the client (3) the more costs that are classified as direct, the lower the indirect rate may be and (4) since the theoretical goal is to allocate all costs directly to specific final cost objectives, the more costs that are direct the more precise and hence closer to the goal.

The FAR defines direct costs as "No final cost objective shall have allocated to it as a direct costs any cost, if other costs incurred for the same purpose in like circumstances have been included in any indirect cost pool to be allocated to that or any other final cost objective. Direct costs of that contract shall be charged directly to the contract." The definition in the Cost Accounting Standards is more pointed – "Direct cost means any cost which is identified specifically with a particular final cost objective."

Both the FAR and CAS contain safeguards against inequitable cost allocations that would result if costs incurred for the same purposes under like circumstances were charged direct to some cost objectives and indirect to others. CAS 402 contains an illustration of costs that appear similar but are not incurred for the same purpose – in addition to 10 firemen employed for protection of the plant, which are charged indirect, the contractor also uses 3 firemen to protect flammable materials for one contract, which are charged direct to that contract. Such different treatment of apparently similar costs must be disclosed as showing the different purposes for each type of costs. Examples of similar sometimes direct and sometimes indirect expenses include tooling costs (general versus special), security costs (general versus special facilities), training (training benefiting all contracts versus required or benefiting only one contract), software (common-use versus special purpose needed for one contract) and meeting costs (general meeting versus contract-specific).

A long established approach to identifying direct costs is the "but for" rule – if a cost would not have been incurred "but for" the contract, that indicates it is properly allocable to the contract while if it would have been incurred even if the contract did not exist, then it would more properly be an indirect cost. This "but for" rule is "causal" – the contract caused the cost to be incurred but sometimes a better approach might be a "beneficial" basis – the cost benefited one or more contracts. Sometimes there is a conflict that needs resolution using judgment – for example, a government contract may have *caused* a company to install a security fence but the fence *benefited* all company work.

Both the FAR and CAS use materiality considerations. For practical purposes, any direct costs of a minor dollar amount (not defined) may be treated as an indirect cost provided the accounting treatment is consistently applied and the result is substantially the same (again not defined). This concept is often incorporated in the term "blanket costs" where examples may include miscellaneous small parts or product inspection labor. Contractors may have the option of considering these costs to be indirect or they may be pooled and allocated directly to final cost objectives on some appropriate base. We find that care should be taken to ensure the government will pay for these costs directly – it is quite common for them to assert these costs will only be paid indirectly where if they were proposed direct and hence excluded from the indirect cost pool, recovery would be precluded.

Treatment of Specific Costs

Shortly after promulgating the cost accounting standards the CAS Board issued a 1979 summary of disclosure statement responses in what costs were considered direct and indirect. Though it is surprising that more current surveys have not been made (a useful research topic for an enterprising scholar, we would think) we find the survey results are substantially timely for today. (*Editor's Note. In fact, we find there are many more opportunities for flexibility than the survey implies.*)

♦ Costs that are Generally Indirect

Some costs are generally charged indirect even though they could be tracked and charged direct. For example, though it could be tracked by contract sale of scrap and salvage is commonly indirect primarily due to the materiality and administrative burden of keeping track of which contract created the transaction.

Other categories of costs cause some problems. Purchasing, contract administration and subcontract administration costs are often charged indirectly. However, indirect charging can cause some confusion where such administrative costs can be tracked for large contracts, sometimes requiring dedicated personnel, while smaller contracts would require significant administration effort to identify small amounts of time to each contract and would likely lead to inaccurate timekeeping by employees having little patience recording small blocks of time. When charged indirect, contractors can argue that direct labor or total cost inputs, common allocation bases of overhead and G&A, respectively, do not provide an equitable allocation because of the widely different administrative efforts of different types of contracts. The author suggests an intriguing solution, especially when the contract calls for it: allocate purchasing/contracting efforts directly to "major contracts" and then pool all other purchasing/contracting into a cost center and allocate them as indirect costs only to "non-major contracts." Though some may argue the same cost is allocated direct and indirectly, which violates both the FAR and CAS 402 requirements to treat similar costs consistently, the author argues no contract receives both a direct and indirect allocation so there is no violation.

According to the CASB summary, charging rearrangement costs directly would raise questions of equitable allocations. Though the summary did not address equipment costs DCAA guidance informs its auditors that unless a contract explicitly approves special tooling, equipment or machinery costs the auditor is told to question direct costs of capital items. The author argues that direct costing is more common in non-defense contracts. For example, a contractor storing specimens in a refrigerator would more appropriately direct charge the refrigerator to that contract(s) that utilizes it since not all contracts may use the refrigerator equipment.

The cost of overnight mailings, courier services, long-distance telephone calls, cell phones, facsimile messages, copying, automobile mileage, software, supplies, office space and similar items are generally charged indirect. Though these costs could be identified to specific cost objectives direct charging of these costs would require significant administrative effort. There is probably greater justification for indirect charging of these items now than in the 70's since the costs of, for example cell phones, faxes and software have gone down resulting in less benefit of tracking such costs. Similarly, reproduction costs are now often integrated with computers and printers and need not be tracked separately.

♦ Costs Generally Charged Direct

The Summary report disclosed that freight in and out, design engineering, drafting, shift premiums, preproduction costs, line inspection, travel, packaging and preservation, royalties, warranties, rework and scrap work were generally charged direct. The decision to charge these costs direct was influenced mainly by materiality considerations.

DCAA acknowledges that warranty costs may be consistently recorded as either direct or indirect and offers the following guidance. When the warranty costs are included in overhead the auditor is told to determine that the base for allocating this expense is made up only of contracts containing warranty provisions. When evaluating direct charges of warranty costs the auditor is to ascertain whether the same types of costs incurred on other government or commercial products are excluded from allocable

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overhead unless "it is clearly established that a cost duplication does not exist."

Other Considerations

Costs That are Predominantly Direct. Other costs that were almost exclusively charged direct included subcontracts, trade discounts, refunds, and allowances on purchases, purchased labor (on-site and off-site), special tooling and special equipment. DCAA urges its auditors to ensure that that the contract where special tooling and equipment are direct charged provide for it and if they are unauthorized, DCAA is to ensure such items are not included in other direct charges such as materials, supplies or miscellaneous costs.

Unique Situations. Sometimes costs that would be considered indirect in most circumstances are properly direct costs if unique circumstances apply. The Summary indicated that certain employee related costs such as health insurance, pension and vacation pay were charged direct by a minority of firms. This is common, for example, for service contracts under which employees are dedicated to a single contract and distinguishing between direct and indirect labor is not important because all employees are considered to be charged to the contract. Under such circumstances, a court held that vacation pay was properly classified as direct labor.

Costs Not Direct or Indirect. Several costs reported in the Summary are neither clearly direct nor indirect. These costs include overtime premiums, cash discounts, incoming material inspection, inventory adjustments and holiday differential pay. For overtime premiums, DCAA states though it is commonly treated as an indirect expense, it may be acceptable as a direct charge when it is the contractor's policy to do so. Cash discounts are normally small and infrequent so are recorded as indirect since tracking these costs would be an administrative burden. Incoming materials inspection as a direct costs can be problematic, especially with uses of material resources planning systems. Inventory adjustments may be difficult to track to specific contracts especially when two or more contracts use the inventory. Holiday differential may be direct as an ODC or overhead or even sometimes as a fringe benefit cost. However, inclusion as a direct cost runs into similar problems associated with overtime premiums – its difficult to attribute to one contract if an employee works on more than one.

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GCA DIGEST · P.O. Box 1235 · Alamo, CA 94507 · (tel) 925-362-0712 · (fax) 925-362-0806 · Email: gcaconsult@earthlink.net
Website: www.govcontractassoc.com