CHAPTER 12

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CHAPTER 12

12-000 Auditing Contract Termination, Delay/Disruption, And Other Price Adjustment Proposals Or Claims

12-001 Contract Terminations and Equitable Price Adjustments

This chapter describes procedures for auditing cost proposals under contracts and subcontracts which have been partially or fully terminated before completion. This chapter also provides guidance for contract price adjustments resulting from the following situations: changes in the work made by the contracting officer within the general scope of the contract; changes in the work resulting from abnormal conditions, such as delay/disruption; or extraordinary relief under 50 U.S.C. 1431-1435.

12-100 Section 1 --- Contract Termination Procedures---Overview

12-101 Introduction

a. This section provides general information on contract terminations. It also discusses the principles and procedures governing audits of settlement proposals submitted under terminated contracts and subcontracts. These principles and procedures serve as a guide and are not meant to limit professional judgment. The purpose is not to restate information contained in FAR Parts 31, 45.6, and 49 except when necessary for clarity. A knowledge and understanding of these FAR sections is essential in performing an adequate audit of terminated contracts. Refer, as necessary, to applicable FAR Supplements issued by the various agencies that relate to terminated contracts. As used in the termination sections of this chapter, the term "contracting officer" usually means termination contracting officer (TCO).

b. The right of the Department of Defense to terminate Government contracts is important in maintaining military procurement flexibility and obtaining the maximum use of procurement funds. Each DoD contract must include a termination clause.

c. When terminating a contract, one of the Government's basic objectives is to promptly negotiate a settlement which will pay the contractor for the preparations made and the work done under the terminated portions of the contract. When appropriate, the Government allows a reasonable profit on work performed. However, if analysis indicates a loss would have occurred if the contract had been completed, the Government adjusts the contractor's proposal accordingly. When the contractor does not present a settlement proposal within time limits provided, the contracting officer may determine the amount to be paid to the contractor. The same is true when the Government and contractor cannot settle on an amount. When authorized by the contract, the Government can make partial payments pending settlement of the claim.

d. A termination may be at the convenience of the Government or for default. The amount a contractor is entitled to receive depends in part on the cause for termination and the type of contract involved. FAR 49.403 discusses termination of cost-reimbursement-type contracts for default. Terminations of fixed-price contracts for default do not usually require audit services.

e. Refer to FAR Part 12 for regulations regarding termination of commercial contracts. Terminations of commercial contracts do not require audit services. The Government has no authority to audit the contractor's records that support a proposal related to the termination of a commercial contract for convenience.

f. A termination may be either partial or complete. A contract is completely terminated when the termination notice directs the immediate cessation of all remaining contract work. Under a partial termination, the contractor continues to perform on the unterminated portions of the contract following the existing contract terms.

g. No-cost settlements occur when:

(1) the contractor has not incurred any costs for the terminated portion of the contract,

(2) the costs incurred are not significant and the contractor is willing to waive payment,

(3) the contractor can divert all costs including termination inventory to other orders, or

(4) for some other reason the contractor agrees to a no-cost settlement.

h. The "Truth in Negotiations Act" (10 U.S.C. 2306a), and FAR 15.403-4 requiring certified cost or pricing data, apply to termination actions. For termination settlement proposals exceeding $700,000, the contractor must certify that the cost or pricing data submitted was accurate, complete, and current as of the date of agreement on the settlement.

i. A termination proposal submitted under a termination clause is not a claim because it is submitted for the purpose of negotiation. However, a termination proposal becomes a claim under the Contract Disputes Act (CDA) upon the occurrence of one of three events:

(1) the contractor's submission indicates that the contractor desires a final decision and the contracting officer does not accept its proposed terms,

(2) negotiations between the TCO and the contractor are at an impasse, thus implicitly requiring the TCO to issue a final decision, or

(3) the TCO issues a final decision.

Refer to 12-504 for further guidance on CDA claims.

12-102 Contract Modifications Causing Subcontract Terminations

Not all termination settlements result from contract termination. Modification of a contract, according to the changes clause, may require a termination adjustment. A change in specification, for instance, may make unnecessary the particular materials or parts that a prime contractor has on order. As a result, the prime contractor may need to cancel one or more subcontracts. This, in effect, is similar to a termination of the prime contract for the convenience of the Government. The standard subcontract termination clause (FAR 49.502(e)(1)) gives the prime contractor the right to cancel subcontracts for its own convenience. It also defines the rights and obligations of the subcontractor. When modifying a prime contract according to the changes clause of the contract, the contracting office may ask DCAA to audit the prime contractor's proposal for an equitable adjustment in the contract price or the estimated cost and fee. In these instances, follow the procedures set forth in 6-800 to ensure that any subcontract settlements resulting from the change are reasonable.

12-103 Partial Termination

a. A partial termination of a contract may require a separate equitable price adjustment of the continuing portion of the contract as provided in the standard termination clause for fixed-price contracts. The contractor must file the request before settling the terminated portion of the contract. While a request for equitable adjustment may be submitted as a result of a partial termination, it is a separate action from the termination settlement proposal. The request for equitable adjustment is subject to the same requirements, including certification requirements, as equitable adjustment proposals or claims submitted in other circumstances. Refer to 12-500 for further guidance on equitable adjustments. Examples of partial termination situations normally considered acceptable for an equitable adjustment on the continuing portion of the contract follow:

(1) A volume decrease that increases material, labor, or indirect unit costs. The contractor may no longer be able to take advantage of quantity discounts. Direct labor unit costs may increase because the work reduction may prevent the contractor from realizing labor improvement (learning) curve benefits projected in the negotiated price. Labor unit costs may also increase because there are fewer units over which to distribute setup costs. Indirect cost rates may increase when assigning fixed overhead charges over a lesser volume.

(2) Initial (starting load) costs may not be recovered due to the partial termination.

b. Ensure that equitable adjustment claims do not include costs already covered by the termination settlement or costs not caused by the partial termination.

12-104 Applicable Cost Principles - Termination Audits

a. For fixed-price contracts, the Government settles terminations for convenience using the "termination for convenience" contract clause, other applicable contract clauses, and the contract cost principles contained in FAR Part 31, in effect on the date of the contract. Cost provisions of the subpart of FAR Part 31 referenced in the allowable cost and payment contract clause govern cost-type contract settlements.

b. The auditor may find references to cost principles other than FAR 31, particularly DAR XV. When found, the referenced cost principles and regulations apply and must be used.

12-105 Influence of Cost Accounting Standards

a. CAS 401 requires the contractor to accumulate and report costs in the same way as estimated. Cost estimates used in a prospective contract normally anticipate the contract going to completion. Cost arrangement in a termination claim may differ significantly from the cost presentation contained in the original estimate. A contract termination in essence creates a situation that is totally unlike a contract completion. Therefore, it is not reasonable to extend the consistency requirement to an event not anticipated in the original estimate.

b. While termination procedures usually comply with CAS 401, a contractor would breach the consistency requirement if it had several similar terminations and handled them differently. Audit the contractor's termination procedures for consistency.

c. CAS 402 requires a contractor to classify consistently all like costs in like circumstances as either direct or indirect. Termination claims often include as direct charges costs or functions which would have been charged indirect if the contract had been completed (FAR 31.205-42). Examples are settlement expenses and unexpired lease costs. These circumstances do not breach CAS 402 requirements since the like circumstances referred to in the Standard are lacking.

d. CAS 406 requires that a contractor use its full fiscal year for its cost accounting period.

12-200 Section 2 --- General Audit Guidance For Terminations of Negotiated Contracts

12-201 Introduction

a. This section provides audit guidance for terminations of negotiated contracts which applies regardless of the cause of termination, the type of contract or the type of claim submitted. Terminations of commercial contracts are discussed in 12-101e.

b. FAR 49.107 requires the TCO to submit prime contractor settlement proposals over $100,000 to the contract auditor for audit and recommendations. It also requires the TCO to request audit of certain subcontractor proposals before approving their settlement (see 12-204). The TCO may also request audit for other prime or subcontract proposals at his or her discretion. In certain conditions, the auditor may also initiate an audit, when warranted as provided in 12-205 and 6-802.5.

12-202 Scope of Audit

a. Establishing audit scope depends on various factors including:

(1) the termination proposal or claim amount;

(2) whether the contractor used the inventory or total cost basis;

(3) the condition of the contractor's books and records;

(4) prior experience with the contractor;

(5) effectiveness of the contractor's internal controls, management decisions, and policies;

(6) how effective contractor personnel are in implementing policies before and after the termination;

(7) the expressed desires of the contracting officer; and

(8) the provisions of the termination clauses in the contract.

b. In determining audit scope, evaluate the contractor's accounting and termination policies, practices, and internal controls. Also evaluate whether the costs claimed in the settlement proposal are consistent with the contractor's normal accounting and termination procedures. Review fundamental contract data to initially test the contractor's proposal. Fundamental contract data includes the price proposal, cost estimates, bills of material, production schedules and records, shipping documents, purchase orders, and cost and profit forecasts. Other sources of information useful in determining audit scope are copies of financial statements audited by the contractor's public accountants, tax returns, reports submitted to Government regulatory agencies, and information from Government technical personnel who have a direct interest and knowledge of the various phases of the contractor's operation.

c. A need for extending the audit scope and performing a more detailed examination of the proposal may be indicated when:

(1) the unit cost level of the quantities shown in the inventory or the quantities themselves do not follow the pattern normally experienced by the contractor,

(2) overhead and administrative expense rates used in the proposal are not typical of past or current experience,

(3) previous audits questioned or disapproved significant costs,

(4) the proposal includes substantial amounts for nonrecurring or other unusual costs,

(5) there appear to be procedural differences between the costing of the completed work and the termination claim, or

(6) inconsistencies are noted in the contractor's costing of termination claims.

d. The auditor should address any specific concerns contained in a contracting officer's audit request (see 4-104 for guidance on acknowledging the audit request). However, it is the auditor's responsibility to determine audit scope. Differences between the contracting officer's requested services and the audit team's assessed risk which cannot be resolved should be elevated to the Region.

12-203 Auditing Terminated Subcontracts

a. Settling subcontractors' termination claims is a prime contractor responsibility. However, the Government has an interest in these settlements when it affects the cost of a prime contract with the Government. The contracting officer must approve or ratify each subcontract termination settlement. An exception to this occurs when the TCO authorizes the contractor to settle subcontracts under $100,000 without his or her approval or ratification.

b. Before approving or ratifying each subcontract termination settlement of $100,000 or more, the contracting officer must request a DCAA audit or an analysis of the audit performed by the prime contractor or higher-tier subcontractor (see 12-310). He or she may also request audits of smaller settlements (see 6-802.5). Careful planning and close coordination among the prime contractor, the contracting officer, and the auditor are necessary to ensure efficient and timely settlement of subcontract termination proposals. This is particularly important when the termination action involves a large and complex prime contract (such as for a major weapon system).

12-204 Responsibility of DCAA Auditor at Prime Contractor Location

The DCAA auditor of the prime contractor is responsible for ensuring that the prime contractor performs adequate audits of subcontract termination claims. The auditor will inform the contracting officer of instances where the contractor failed to properly consider audit findings in settling subcontract termination claims.

12-205 Preliminary Conference with Contractor

a. The contracting officer usually arranges for an initial conference with the contractor (FAR 49-105(c)). He or she normally holds this meeting after the termination notice, but before the contractor submits its settlement proposal. When possible, the auditor should attend the conference and determine the basis and method the contractor plans to use in preparing and costing the proposal. Assist the contracting officer by explaining the cost principles that apply and if necessary furnishing the contractor information on preparing a termination claim (see 1-508). Discuss with the contractor during the preliminary conference any specific problems and questions concerning the termination claim.

b. The preliminary conference also provides the auditor an opportunity to:

(1) arrange for access to the contractor's books and records,

(2) determine the contractor's knowledge and experience in preparing termination claims,

(3) discuss the contractor's plans for settling any subcontractor's claims, and

(4) make a preliminary review of the contractor's records to determine whether the contractor can submit a proposal on an inventory basis (see 12-301.1).

c. Timely planning is essential to ensure that minimal settlement expenses will be incurred and charged to the terminated contract. For example, in large and complex contracts involving a complete or substantial partial termination, the termination contracting officer normally requests the contractor to submit a projected statement of work involved in contract settlement. This statement usually identifies personnel requirements to specific work phases and target completion dates for each work phase. If the contracting officer tells the contractor that using separate work orders or codes is necessary to document settlement costs, obtain a copy of the statement.

d. Obtain a copy of any report that the contracting officer prepares as a result of the preliminary conference. If the meeting includes discussions on accounting or auditing matters, the auditor may wish to prepare a supplemental memorandum of the meeting.

e. When the contracting officer does not arrange for a preliminary conference and the auditor considers it appropriate, he or she should arrange for a meeting. Meet with the contractor and other Government representatives as appropriate. Prepare a memorandum of the meeting and retain it in the audit working papers.

12-206 Unadjusted Pricing Actions

The contractor may have other outstanding pricing actions related to a terminated contract. These may be due to specification changes, redetermination, incentive provisions, or escalation provisions not completed at the time of termination. The contractor should not submit pending price adjustments as an integral part of the termination settlement proposal. However, the Government cannot evaluate the settlement proposal without their concurrent consideration. Personnel responsible for negotiating the price adjustment may not be the same as those responsible for negotiating the termination settlement. Bring any unadjusted pricing actions noted to the contracting officer's attention so that he or she may consider them in the termination settlement. Large outstanding actions may prevent the auditor from reaching a conclusion on the contractor's profit or loss potential under the terminated contract. Base the audit report on the contract prices in effect at the time of the audit. Give the contracting officer full particulars on any pending price adjustments. This allows the contracting officer to provide for a recomputation of the profit or loss allowance after settling the outstanding pricing actions.

12-207 Determinations of Settlement Review Boards

For all major termination settlements and other settlements known to contain problems of an unusual nature, obtain information concerning any settlement review board's determinations (see FAR 49.110 and 49.111), which relate to the audit recommendations. While obtaining the review board's decisions may not alter the auditor's position in subsequent reports, this information may assist him or her in presenting findings so future reports will be more useful.

12-300 Section 3 --- Auditing Terminations of Fixed-Price Contracts

12-301 Introduction

a. This section presents guidance on auditing fixed-price contracts terminated for convenience of the Government.

b. Contractors may submit settlement proposals under terminated fixed-price contracts on either an inventory basis on Standard Form (SF) 1435 or on a total cost basis on Standard Form (SF) 1436. Under unusual circumstances, the contracting officer may approve some other basis.

12-301.1 Inventory Basis

The inventory basis requires that the contractor directly associate the costs and profit in the settlement proposal with units or services terminated. It limits the proposal to those items which are residual due to the termination action. Using the inventory basis for submitting settlement proposals is the method preferred by the Government (FAR 49.206-2(a)).

12-301.2 Total Cost Basis

a. In contrast, a settlement proposal on a total cost basis (FAR 49.206-2(b)) is for total costs incurred under the entire contract up to the effective date of termination. SF 1436 shows cost by element such as labor, material, and indirect costs. Other entries on SF 1436 are available for costs of settlements with subcontractors, applicable settlement expenses, and profit (or loss) adjustment. Applicable credits for the contract price of end items delivered or to be delivered and accepted, unliquidated advance or progress payments, inventory disposal, and/or other credits will also be entered on the SF1436, if applicable.

b. The total cost basis is required for construction and lump-sum professional services contracts that are completely terminated. For other fixed-price contracts when the inventory basis is not practical or would unduly delay the settlement, the total cost basis may be used if approved in advance by the TCO. The following examples are situations where the contracting officer might permit using the total cost basis:

(1) If production has not started and the accumulated costs represent planning and preproduction or "get ready" expenses.

(2) If, under the contractor’s accounting system, unit costs for work in process and finished products cannot readily be established.

(3) If the contract does not specify unit prices.

(4) If the termination is complete and involves a letter contract.

c. If requested by the contracting officer, provide a recommendation on the practicability of using the inventory basis. Base the recommendation on the evaluation of the information obtained during the preliminary conference between the TCO and contractor (12-205). If the auditor receives a request to audit a termination settlement proposal prepared on the total cost basis and the contractor presents no evidence of TCO approval, contact the TCO. If the auditor, based on his or her evaluation of the contractor's records, believes the contractor should use the inventory rather than the total cost basis, inform the TCO.

d. The contractor should prepare a total cost basis settlement proposal for a partial termination the same way as one prepared for a complete termination. However, when a total cost basis is used under a partial termination, all costs incurred, to the date of completion of the continued portion of the contract must be included in the settlement proposal. Settlement proposals for partial terminations submitted on the inventory basis do not depend on completion of the continuing portion of the contract.

12-302 Preliminary Audit Steps

a. Upon receipt, make a general evaluation of the terminated contract, the termination notice, and the contractor's settlement proposal and supporting schedules. The purpose is to determine whether the proposal contains the information and data needed to plan and perform the audit. A proper initial evaluation of a settlement proposal determines whether:

(1) the proposal generally conforms with requirements,

(2) each cost item claimed is allowable according to contract provisions,

(3) the amount claimed is reasonable considering the contract price of the physical units represented by the claim, including whether the contract would have resulted in a loss, or reduced profit if it had been completed,

(4) there is any duplication of charges,

(5) each subcontractor's claim applies to the Government's termination action and not to changes or cancellations for the contractor's convenience, and

(6) the contractor promptly complied with the termination notice by stopping all in-house contract effort promptly and by immediately notifying subcontractors to stop work (see 12-305.7).

b. The introductory portion and Section I of settlement proposals prepared on the inventory basis or total cost basis, are essentially the same. Section I gives the contract status as of the cut-off point or effective termination date. Comparing this section with the contractor's proposed settlement amount, as shown in Section II, may disclose inequities or areas requiring further evaluation. To verify the accuracy of the data contained in Section I, examine:

(1) the contract to determine the materials or services to be supplied, the prices to be paid, and the delivery schedule,

(2) the termination notice and its effect on the contract,

(3) shipping records and invoices for the delivered items,

(4) specific termination instructions given by the contracting officer,

(5) the contractor actions taken to comply with the termination notice to minimize termination costs, and

(6) the projected profit or loss on the contract.

c. Computing the net claim in Section II of a settlement proposal prepared on an inventory basis (Standard Form 1435) differs substantially from that used on a total cost basis (Standard Form 1436). The main difference is that Standard Form 1435 includes only the cost of residual inventory, plus appropriate "other costs" (12-305). Standard Form 1436 shows total costs incurred in performing the entire terminated contract. To compute these total costs shown on Standard Form 1436 the contractor first adds applicable profits to the total costs. The contractor then reduces the amount by the contract price of delivered (or expected deliveries) finished products.

d. Compare the contractor's costs listed in Section II, plus any subcontract settlements, with the information in Section I. The results may indicate a possible overstatement of the claim or evidence of a loss situation. The contractor should not use the termination settlement proposal as a means to recover losses or expected reduced profit on the contract. Review contract costs and the reasonableness and accuracy of the estimate or budget to complete to determine whether a loss or reduced profit would have been incurred if the contract had not been terminated.

e. Compare Section II amounts with the related totals on the inventory schedules and with Schedules A through H of the proposal. When the proposal is on the total cost basis, confirm that the contractor properly credited the proposal for finished units. A review of the supporting schedules may suggest areas requiring further analysis.

f. Verify that the total amount payable to the contractor for a settlement, before deducting disposal or other credits and exclusive of settlement costs, does not exceed the contract price less payments otherwise made or to be made under the contract (FAR 49.207).

g. Determining whether a loss would have occurred depends, in most cases, on the stage of completion at termination. For contracts with little work completed when terminated, it may be necessary to assume no loss would have occurred unless evidence suggests otherwise. For contracts with substantial effort already completed, verify that the termination proposal includes a cost estimate to complete the contract. The estimate should help the auditor decide if the contract would have resulted in a loss if completed. Make the request for an estimate to complete through the contracting officer. Use the guidance in 9-306 in deciding whether to use technical specialist assistance when evaluating the estimate to complete.

12-303 Preparing the Audit Program

After completing the preliminary review of the settlement proposal, prepare an audit program and begin the audit of amounts contained in Section II. The comments which follow contrast the usual approach to the audit of a proposal prepared on the inventory basis with a proposal prepared on a total cost basis.

12-303.1 Proposals Using the Inventory Basis

The audit effort on an inventory basis proposal mainly deals with reviewing items listed in the inventory schedules supporting the proposal. Make sure the claim includes only items allocable to the terminated portion of the contract. Guidance for the review of the various classes of inventory items follows:

a. Metals, raw materials, and purchased parts included in inventory represent items the contractor has not placed into fabrication or assembly operations. The cost claimed for these items in termination usually should not include amounts for labor or manufacturing overhead. Review the material cost and any material handling charge included by the contractor. Perform tests of the inventory pricing and determine if material quantities apply to the terminated portion of the contract. Make this determination by examining supporting bills of material, cost records, invoices, and purchase orders. Determine whether the contractor screened and removed from inventory all items usable on other work without loss and all items returnable to suppliers (see 12-304.5).

b. Finished components and work-in-process are termination inventory items fabricated, processed, or otherwise changed by the contractor through its manufacturing processes. Work-in-process inventories may present problems in verifying direct material, direct labor, and overhead costs applied to units and components in various stages of production. The contractor may have calculated prices using actual or standard cost or it may have been necessary to use estimated cost (see FAR 49.206-1(c)).

(1) Evaluate extensively statistical type cost data, not controlled by general ledger accounts. Include in this examination available cost data, cost reports, cost standards, engineering and bid estimates, bills of material, and other information influencing the cost. Resolve whether the contractor can retain work-in-process or finished components for use on other work without loss. Also be alert to raw material and purchased parts being improperly classified as work-in-process and finished components due to the greater profit rates allowed on these termination inventory categories. Additionally, the contractor might have overlooked raw material or purchased parts improperly classified when screening items returnable to vendors or diverted to other contracts (see 12-304.5).

(2) Some accounting systems do not provide enough detail on parts or lot costs. In these cases, the use of estimates may become necessary. One acceptable method for developing labor cost is to estimate hours expended on the work-in-process inventory by each labor category at each step in the production process. The estimated hours are then costed at the hourly rates applicable during the performance period. Close liaison with Government technical personnel is required to ensure that the method used and the resultant costs are reasonable.

c. Miscellaneous inventory usually includes items and supplies which do not fit into the above categories. The contractor should limit cost claimed for miscellaneous inventory to material cost, plus handling charges when applicable. Of main concern to the auditor is whether the contractor can use the miscellaneous inventory items without loss or return it to suppliers.

d. Acceptable finished product represent completed end items accepted by the Government but, on instructions from the contracting officer, are not delivered. The contractor may include completed items in the termination schedules. The contractor, however, should list them at the contract price, adjusted for any savings in freight or other charges, together with any credits for their purchase, retention, or sale. Test the adequacy of adjustments made by the contractor. Determine whether completed items are fully acceptable by referring to the inventory verification report (see 12-304.1) or by requesting assistance from Government technical personnel. When rework is necessary to make otherwise completed items fully acceptable, question the estimated rework costs (see 12-304.7).

12-303.2 Settlement Proposals Using the Total Cost Basis

A total cost proposal eliminates the need to evaluate the cost allocation between the completed and terminated portions of the contract. The audit will usually start by examining the total cost incurred under both the completed and partially completed portions of the contract. Audit objectives are to determine whether:

(1) the totals included in the proposal for material, labor, and overhead have been reliably computed,

(2) the costs are allocable and reasonable, and

(3) acceptable accounting evidence is available to support the charges.

Chapter 6 discusses procedures for auditing incurred cost. These procedures also apply to the audit of costs appearing in Section II of Standard Form 1436.

a. Examining inventory schedules becomes important, not so much for the cost of residual inventory, but in determining if the contractor has scheduled all inventory and made it available to the Government for retention, sale, or other disposition. Under a claim submitted on the inventory basis, the Government only pays for residual inventory when listed and priced on the inventory schedules supporting Standard Form 1435. However, a claim submitted on Standard Form 1436 is for total contract costs; thus, all costs applicable to contract inventory are being claimed. It is important to ensure that the termination inventory schedules show all inventory costs billed to the Government. Comparing these schedules with the most recent physical inventory may help in deciding if inventory quantities reported are reasonable. Evaluate any discrepancies between the two inventories.

b. The contractor's total cost claim should include a credit for any common items which have been diverted to other production and for money received from disposing of nonreworkable rejects.

12-304 Auditing Termination Inventory

a. The comments contained in the following subparagraphs apply whether the contractor prepared the settlement proposal on Standard Form 1435 or 1436.

b. Evaluating termination inventory requires coordination between audit and technical personnel. Objectives are to:

(1) verify the inventory quantities, quality, and usefulness;

(2) examine reasonableness of the cost and price data; and

(3) determine whether the contractor considered common items and material returnable to vendors.

Verifying inventory quantities, quality, and usefulness are primarily the responsibility of technical personnel. Evaluating inventory pricing and contract costing are primarily the responsibility of the auditor. Do not needlessly duplicate the efforts of the technical inspector.

12-304.1 Inventory Verification Report

a. As part of the settlement procedures, the contracting officer usually arranges for technical representatives to review the termination inventory and to submit an inventory verification report. The plant clearance officer or technical inspector prepares the inventory verification report for the contracting officer's use in achieving an equitable settlement. The purpose of the report is to :

(1) verify that the inventory exists;

(2) determine its qualitative and quantitative allocability to the terminated portion of the contract;

(3) make recommendations on its serviceability and quantitative reasonableness compared to contract production lead times, delivery schedules, and material availability; and

(4) determine whether any of the items are the type and quantity reasonably used by the contractor without loss.

b. Obtain a copy of the inventory verification report from the contracting officer when possible since it is normally useful in establishing audit scope. When the inventory verification report is not immediately available but will become available within a reasonably short period, delay issuing the report until receipt of the inventory verification report. When the inventory verification report is not available, state in the audit report that recommendations were made without examining the inventory verification report.

12-304.2 Termination Inventory Schedules

a. When appropriate, evaluate the termination inventory schedules for evidence of nonallocability and make selective physical counts of items listed in the termination inventory schedules. Under the total cost basis it may be appropriate to include usage tests to determine whether the contractor actually used materials charged in production. If material is not completely used in producing delivered units, determine whether the inventory schedules list residual items in the correct quantities.

b. The contractor must list on separate inventory schedules all Government-furnished property included in the termination inventory. The contractor may not withdraw Government-furnished property from the inventory for its own use without contracting officer approval. Examining Government-furnished property and submitting a report to the contracting officer is the responsibility of the property administrator. The auditor's evaluation of Government-furnished property complements rather than duplicates the property administrator's review. When the audit discloses irregularities in Government-furnished property use or in the inventory listing, include appropriate comments in the audit report.

12-304.3 Material Acquired Before the Date of Contract

a. Material acquired before the effective contract date is usually not allocable to the terminated portion of the contract, on the premise the contractor did not acquire the material for the contract. Exceptions occur when the contractor:

(1) acquired the material as a direct result of the negotiation and in anticipation of the contract award to meet the proposed delivery schedules;

(2) properly placed the material into production on the terminated contract and cut, shaped, built-in, or changed in such a way that it cannot be returned to stock or reasonably used on the contractor's other work; or

(3) acquired the material under a previously terminated contract and treated it as a common item in settling that contract for use on the contract now terminated.

b. Under certain circumstances, the contractor may claim that material acquired before the effective contract date was reserved for contract use, that retention of the material prevented the contractor from using it on other work, and, therefore, the Government should accept the material as part of the termination inventory. Review the validity of the contractor's claim in these instances.

12-304.4 Material Acquired or Produced in Anticipation of Delivery Schedule Requirements

a. In general, the quantities acceptable in termination inventories may include net bill of material requirements for the terminated work plus a reasonable amount for scrap loss.

Contract provisions or prudent business practice may suggest, however, that although otherwise acceptable, the on-hand quantities included in termination inventory schedules are larger than expected at the termination date. This condition may have been caused by the contractor acquiring or producing items by unreasonably anticipating delivery requirements. Excessive materials on-hand resulting from this condition are not allocable to the termination claim. Reviewing the contractor's purchasing policies and practices should assist in determining if this condition exists and in making recommendations to the contracting officer regarding excessive material. In reaching a conclusion, however, consider whether the contractor purchased large quantities of materials due to quantity discounts, favorable market conditions, or the need to have all materials on-hand before starting production. As a pricing factor in quoting the contract price, the contractor may have planned to produce items in large quantities to achieve production economies. Ask for technical personnel assistance when necessary to determine whether procurement or production was unreasonably accelerated.

b. A contract may specify that the Government must approve a preproduction model before delivery of any production units. The contract may also prohibit the contractor from obtaining materials or proceeding with production before the Government can test and approve the preproduction model. When the Government terminates a contract containing these restrictions before preproduction model approval, only allowable design costs and costs incurred for the preproduction model are acceptable as termination costs. The presence of inventory items and costs for making deliverable items may suggest that the contractor unreasonably accelerated production. Ordinarily, these costs would be unallowable.

c. For certain production contracts, the schedule to purchase quantities of basic materials requires contracting officer approval to minimize inventory accumulation. Where these purchasing restrictions exist, determine if the termination inventory quantities agree with the purchasing schedule approved by the contracting officer.

12-304.5 Common Items

a. Common items are material items which are common to both the terminated contract and other work of the contractor. FAR 49.603-1 states that the contractor certifies that all items in the termination inventory do not include any items reasonably usable without loss to the contractor on its other work. Also, FAR 31.205-42(a) states that the cost of items reasonably usable on the contractor's other work shall not be allowable unless the contractor submits evidence that it could not retain the items without suffering a loss.

b. In determining whether common items are reasonably usable by the contractor on other work, review the contractor's plans and orders for current/scheduled production and for current purchases of common items. Also determine whether the contractor properly classified inventory items as common items. Do this by reviewing stock records to see if the items are being used for other work and by reviewing bills of material and procurement scheduled for products similar to those included in the termination inventory. Limit acceptance of common items as part of termination inventory to the quantities on hand, in transit, and on order which exceed reasonable quantities required by the contractor for work on other than the terminated contract. In determining whether the inventory contains common items, the contractor should first assign total available quantity (inventory on-hand, in transit, and on order) to continuing or anticipated Government or commercial

production and assign the remainder, if any, to the terminated contract. The contractor, therefore, should assign to the terminated contract:

(1) the least processed inventory, and

(2) those purchase commitments that result in the least cost when terminated.

c. Under certain circumstances, complex or specialized items may qualify as common items. For example, the compressor unit of a military jet engine might qualify as a common item if the contractor also uses the unit in commercial jet engine production. Or the memory unit of a computer might qualify if the contractor also uses the unit in a commercial computer. The test is whether the contractor can divert the item to other work without loss.

d. Common items need not be so classified if the contractor can show that eliminating the item from termination inventory would cause financial hardship. For example, when raw materials are common to the contractor's other work but the amount resulting from the termination equals a year's supply, or an amount far exceeding the contractor's usual inventory, retaining the material might unfavorably affect the contractor's cash or working capital position and result in a financial hardship. Retaining a large inventory does not in itself, however, permit the contractor to claim an amount for excess inventory. When the contractor can use the inventory within a reasonable period, regardless of size, the excess inventory claim would not be allowable.

e. After submitting the termination settlement proposal, the contractor may receive additional contracts or commercial orders on which it can use the termination inventory items. In these cases, the contractor should withdraw the items it plans to use on the new work, (except for Government property or other items reserved by the contracting officer), adjust the claim accordingly, and notify the contracting officer.

f. Bring to the contracting officer's attention reworkable rejects in the termination inventory which the contractor can divert to other work. The contracting officer may find it in the Government's interest to allow the reworking costs in order to obtain credit for items reworked and diverted.

12-304.6 Production Losses

a. The cost of direct materials for parts, components or end items usually includes the cost of scrap such as trimmings, turnings, clippings or unusable remnants. Other production losses may occur due to testing, obsolescence, or actual physical loss of the components, subassemblies or end items. Depending on which stage in production the loss occurs, the cost involved may be for material or it may include material, labor, and applicable burden. Make sure the contractor credits the value realized from the sale or other disposition of scrap or other production losses either to:

(1) the material cost for the product scrapped or

(2) the overhead allocable to the end product.

b. Review production losses for reasonableness and allocability to the terminated portion of the contract. Allocability is particularly important when the contractor submits the settlement proposal on the inventory basis since a portion of production losses applies to end items completed and shipped. The claim for units terminated should exclude all costs allocable to units shipped. Question unreasonable production losses, evidenced by a significant physical loss of components or subassemblies or by comparison with the loss rate on similar products.

12-304.7 Rejected Items

a. Reworkable Rejects. This type reject includes completed end items that did not meet contract specifications but the contractor would have reworked into acceptable completed articles if not stopped by the termination. The contractor should list these items on termination inventory schedules at their contract prices less the estimated cost to rework them (see 12-304.5f). To avoid possibly duplicating G&A expense and profit, the contractor should not claim reworkable rejects as work-in-process. The auditor normally reviews the estimated cost to rework these rejects to test for proper treatment by the contractor.

b. Nonreworkable Rejects. The contractor usually scraps nonreworkable rejects and does not include them in its inventory schedules. However, the contractor can recover their costs as part of the termination settlement when the costs apply to the terminated portion of the contract. Question any claimed amounts which are allocable to delivered items.

12-304.8 Returning Material to Suppliers

FAR authorizes and encourages contractors to return contractor-acquired termination inventory to suppliers for full credit less, if applicable, a reasonable restocking fee that is consistent with the supplier's customary practices (see FAR 45.602-1(c)(1)(ii)). The contractor may not include the cost of returned property in the settlement proposal but may include the transportation, handling, and restocking charges for the returned property. Except for diversion to other work of the contractor or retention by the Government, this is the preferred method for disposing of termination inventory. Review the termination inventory listing for any items of inventory subject to return. For any items so noted, compute an amount as if the contractor had returned the items to suppliers. Question any resulting differences.

12-304.9 Intracompany Transactions

The cost principles govern allowable charges for materials, services, and supplies sold or transferred between plants, divisions, or organizations under common control. Question any excess charges resulting from the contractor pricing intracompany transactions inconsistently with the provisions of FAR 31.205-26(e).

12-304.10 Termination Inventory Undeliverable to the Government

Termination inventory may not be deliverable to the Government because it was damaged, destroyed, or lost. Treat undeliverable inventory as material purchased and retained by the contractor. Unless the contract provides otherwise or the Government has assumed the risk for loss and damage, deduct the fair value of undeliverable material from the termination settlement proposal.

12-304.11 Completion Stage of Terminated Work

a. As a step in their review of termination inventory, Government technical personnel may determine the overall stage of contract completion at termination. When this is done, compare the relationship between incurred cost and contract price to the physical stage of completion. Although there may not always be a direct correlation between cost incurred and percentage of physical completion, a significant disparity may suggest that a loss-contract situation exists. In these cases, obtain an estimate to complete and compute a loss adjustment (see 12-308).

b. Where the Government terminates only part of the units to be produced under the contract, the contractor should assign the least processed items to the termination inventory. By doing this the contractor keeps its proposal to a minimum (other factors being equal). The contractor might decide, however, to include items in the proposal which are in more advanced stages of production to increase the termination cost and the physical completion percentage of the terminated inventory and thereby earn a higher profit. Make sure the contractor assigns the least processed inventory items to the termination inventory. Two specific test procedures normally used follow:

(1) When termination inventory items are partially complete, determine whether similar items were put into production after the effective termination date, or whether the contractor performed any production steps on similar items preceding the stage of completion of the items included in the termination inventory.

(2) When termination inventory items are complete units or subunits (finished components, subassemblies, etc.), determine whether the contractor worked on them after the effective termination date.

c. A yes answer to either of the above situations would normally suggest the contractor did not assign items which were in the least stage of completion to the termination inventory. Question any excess costs resulting from the contractor's failure to assign the least processed items to the termination inventory.

12-304.12 Obsolete Materials and Tooling

Where the Government made a previous change in the design or specifications of the end products terminated under a contract and the proposed settlement is on an inventory basis, review the termination inventory items to determine whether the inventory includes items that may have become obsolete due to the contract change. Do not accept obsolete materials and tooling costs as part of the termination inventory if the contractor received consideration for costs attributable to obsolescence by negotiating an equitable change in contract price of items delivered. Where the contractor waived adjustment of the contract price because there was enough in the original price for the contractor to absorb the cost of the obsolete material and the Government later terminates the contract, the contractor may not then make claim for the obsolete materials in its termination settlement proposal. The contractor's previous decision to absorb the costs is binding.

12-304.13 Special Tooling

a. Verify that items the contractor claims as special tooling agree with the definition of special tooling in FAR 2.101b. When the contractor can use the tooling on other work, it

does not qualify as special tooling, and the costs are not allocable to the terminated portion of the contract. In many cases, obtaining a technical opinion on whether claimed special tooling meets the definition contained in FAR may be appropriate.

b. The contractual intent of the Government and the contractor on reimbursing special tooling costs affects their allowability. The Government may intend to reimburse the contractor as part of the product price or as a separate contract line item.

(1) When there is no indication on the method for reimbursing special tooling costs, assume reimbursement through the product price. Thus, the costs are allocable to both the terminated and nonterminated portions of the contract.

(2) If special tooling represents a separate, nondeliverable contract line item, the contractor may claim tooling costs only if it has not previously received payment for the tooling. In this case, regardless of the amount expended on tooling, the Government would limit recovery in the termination settlement to the line item price less any payments previously received for tooling.

(3) When special tooling is a contract deliverable item, the contractor is paid the contract price only if the tooling is available. If portions of the tooling have been consumed, lost, or are otherwise unavailable, the Government reduces the contract price of the tooling for this as well as for previous payments.

c. Question special tooling costs when:

(1) The contractor acquired the special tooling before the date of the contract, or as a replacement of items so acquired.

(2) The special tooling claimed is actually consumable small tools or items more appropriately classified as capital goods.

(3) The special tooling exceeds the contract requirements. For example, when the contract is for designing and producing a prototype unit and only a few experimental parts are needed, the contractor should normally not purchase special tooling intended for mass production. The contractor may have exceeded requirements based on expected future contracts.

d. The usefulness of the special tooling may have been expended during the production of the finished and delivered units. No part of such tooling costs would be allocable to the terminated portion of the contract. All or a portion of the special tooling required may relate only to the terminated units not entered into production. Therefore, all or a portion of the tooling cost incurred to the termination date would be allocable to the completed portion of the contract.

12-304.14 Special Machinery and Equipment

a. Auditing special machinery and equipment costs included in termination settlement proposals is similar to auditing special tooling costs. Determining that a particular item of machinery or equipment is "special" is usually a technical matter. Also, a legal opinion on the intent of the contracting parties may be needed. To qualify as "special," the equipment or machinery must be of a type rarely used in the contractor's industry (i.e., peculiar to the needs of the Government). Do not consider machinery or equipment special when it is:

(1) ordinary or normal-type equipment in the contractor's industry,

(2) similar to other facilities owned by a contractor, or

(3) usable on other work without loss to the contractor.

b. Allowability of loss on special machinery or equipment depends on the original intentions of the contracting parties. When a contract requires that a contractor purchase certain special machinery or equipment to perform the contract, and the Government considered the cost when setting the contract price, the contractor can recover the loss of useful value of the special equipment at termination. The maximum allowance for loss of useful life, however, should not exceed that portion of the equipment cost considered in establishing the contract price which applies to the terminated units.

c. When the special equipment purchase was not specifically considered during the contract negotiations, reimbursement for loss of its useful value is not automatically discounted, though it may raise a question about the "special" nature of the equipment. A usual consideration in granting a contract is that the contractor has the equipment to do the work required and meet delivery schedules. The auditor may have good reason to question the cost when, for example:

(1) the contractor continues to use the machinery on other work,

(2) the contractor owned the machinery before the contract date, or

(3) the contractor is unwilling to transfer title to the Government if the transfer is required upon honoring the termination claim.

12-304.15 Indirect Costs – Termination Inventory

a. Audit the makeup of the indirect cost pools and how the contractor distributes them to determine the propriety of indirect costs assigned to the termination inventory. Section 6-600 provides the techniques for auditing indirect cost pools and indirect cost allocation. Section 12-309 discusses the application of indirect costs to termination effort. In auditing indirect costs assigned to the termination inventory, determine that the amount does not include allocations for indirect cost items which are the same or similar to those claimed elsewhere in the settlement proposal as direct charges under other direct costs, settlement expenses, material handling charges, or other cost categories. Confirm that the termination inventory excludes indirect costs not properly allocable because of the completion stage of the terminated inventory. For example, packing, shipping, and inspection costs would not apply to undelivered items.

b. In some cases, the contractor may need to deviate from its normal costing practices to properly assign certain indirect costs to the termination inventory. Section 12-105 discusses the influence of Cost Accounting Standards.

c. Contractors may request permission to leave packing and shipping expenses in overhead pools. In return the contractor will pack and ship the termination inventory without any other specific charge. If such arrangements increase the claim, question the additional costs.

12-305 Auditing Other Termination Costs

a. Costs other than settlement expenses applicable to the terminated portion of the contract, which are not claimed in other cost categories, may be claimed under "Other Costs." Other costs (see 6-500) frequently include such items as initial costs, engineering costs, royalties, severance pay, rental costs under unexpired leases, travel costs, and costs continuing after termination. Perform tests to ensure that the contractor has not claimed other costs on a direct charge basis while treating the same or similar items as indirect charges.

b. One problem facing the auditor in auditing other costs such as severance pay or rental costs under unexpired leases, is determining the reasonableness of the amounts claimed. Since there may not be any direct relationships between the amounts claimed for these types of items with the cost of material, labor, and overhead in the termination inventory, examine the basic agreements under which these costs were incurred. Also evaluate their allocation to the terminated portion of the contract, and determine whether the contractor gave proper consideration to their residual value. A technique used to indicate possible excessive claims for these items is to determine whether including the claimed amounts in the total estimated cost to complete the contract would have resulted in an overall loss. Where the auditor cannot reach a conclusion on the reasonableness of other cost items, classify these costs as unresolved (see 12-313b). Include in the audit report appropriate available information and comments giving your best judgment on their propriety.

c. The ASBCA has ruled (ASBCA No. 16947, Systems Development Corporation (1972)), that when severance pay paid as a mass severance pay per FAR 31.205-6(g)(2)(iii) is determined allowable and allocable as a direct cost to the terminated contract (see 12-305.4), it should not be burdened with labor overhead because it is not attributable to specific work on the contract. Therefore, mass severance pay should be classified so that it is not burdened with labor overhead, for example, as other direct costs.

d. Proper classification between other costs (mass severance costs and costs which would have been incurred under the contract if it had not been terminated) and settlement expenses (costs incurred as a direct result of the termination) is essential because profit is not applied to settlement expenses (to classify mass severance pay refer to 12-305c.).

12-305.1 Initial Costs

a. Initial costs include starting load costs and preparatory costs. The allowability criteria for initial costs are in FAR 31.205-42(c).

b. The two major areas considered in the contractor's determination and the auditor's review of initial costs are the (1) identification of total dollars, and (2) allocation of these dollars to the terminated portion of the contract. Regarding identification, FAR 31.205-42(c)(4) provides, "if initial costs are claimed and have not been segregated on the contractor's books, segregation for settlement purposes shall be made from cost reports and schedules which reflect the high unit cost incurred during the early stages of the contract." To be considered, the contractor must submit the claim for initial costs and be able to support it with reliable data taken from formal or informal records. Contractors rarely segregate initial costs in their formal records or books of account, and, therefore, claims normally involve informal records, cost reports, production data, etc., as well as judgmental estimates. In these cases, evaluate the supporting documentation, the reasonableness of the total amount claimed, and the allocation to the terminated work.

c. One area usually identified with initial costs is the rate of production loss during the early production stages. The contractor should have scrap reports, efficiency reports, spoilage tickets, etc., available to develop and support a claim for a high initial production loss. Another initial cost category that is often readily identifiable is initial plant rearrangement and alterations. The contractor usually sets up a work order or service order to perform this work and accumulates costs against the work order. Management and per-

sonnel organization and production planning costs may be difficult to evaluate. If claimed, the contractor will probably base these costs on estimates, and help from technical specialists may be necessary.

d. The remaining elements of initial costs are defined in FAR 31.205-42(c)(1). They include items such as idle time, subnormal production, employee training, and unfamiliarity or lack of experience with the product, materials or processes involved. Although the FAR states that these costs are nonrecurring in nature, they may occur periodically throughout the life of the contract. As production continues and learning takes effect, these costs should lessen. This learning process may be expressed using an improvement curve as discussed in EZ-Quant. Distinguishing between normal production labor and labor due to idle time, subnormal production, employee training, or lack of experience may be difficult. However, many contractors maintain data on these factors in the form of efficiency reports, equivalent units produced, etc. This data is often acceptable for supporting starting load costs.

e. Once identified, the second consideration is that of assigning the initial costs to the terminated and nonterminated portions of the contract. Usually the contractor can assign initial costs to delivered and terminated units in proportion to their respective quantities. Initial costs which cannot be directly identified but which constitute diminishing costs discussed earlier can be assigned by using an improvement curve (see EZ-Quant). For instance, the contractor can use the learning curve technique to project total direct labor hours if the contract had been completed. Average direct labor hours per unit can then be determined and applied to the delivered units. The quantity so assigned would then be deducted from the total labor hours required to produce the delivered items. The difference can then be costed using historical labor and indirect cost rates, to determine the initial costs allocable to the terminated portion of the contract.

f. Determining if initial costs are reasonable usually involves analyzing the causes of initial costs as well as comparing these costs to those experienced on similar programs. High initial costs may indicate that a loss would have occurred had the contract gone to completion.

12-305.2 Engineering Costs

a. Engineering costs may be claimed as other costs that apply to the terminated portion of the contract. The allocability of engineering costs to a termination claim depends on why they were incurred, whether the contract was completely or partially terminated, and whether the engineering work had been completed by the termination date. Allocability may also be influenced by the type of engineering involved; i.e., whether it was:

(1) for designing and developing the end products,
(2) for preparing drawings or technical manuals,
(3) for production planning or plant rearrangement, or
(4) for designing and developing special tooling, special machinery, or equipment.

b. When the contractor's claim for engineering costs applies to designing and developing the end product, find out whether engineering costs were included in the end product price, or whether the design work is covered by a separate item in the current contract or by another contract. If the costs were included in the end product price and the engineering work is complete, the engineering costs may partially be properly allocable to the terminated portion of the contract. In this case, recommend acceptance of the properly allocable

portion of engineering cost provided the Government's interests and rights to the design are properly protected. If the engineering work is not complete, and there is a continuing portion of the contract to which it pertains, the contractor should not allocate engineering costs to the terminated portion of the contract. As compensation for unrecovered engineering cost, the contractor should apply for an equitable adjustment of the price of the continued items. This latter procedure was adopted to simplify the Government's consideration of these costs.

c. Costs for drawing or technical manuals are usually priced separately from other contract items. Engineering costs for these items are therefore not allocable to the partial termination of other end products.

d. Allocable engineering costs for plant rearrangement and production planning usually are acceptable in a complete termination. However, if the work is not complete at the partial termination date, the contractor's claim should be for an equitable adjustment of the contract price of the continued portion of the contract, rather than against the terminated portion of the contract.

e. When the engineering work is for designing special tooling, machinery, or equipment, consider the costs as allocable to or part of the special tooling or equipment, rather than to the end product. When the contract contains a separate item for special tooling or equipment, or when there are diverse end products, considering the design costs as applying to the tooling or equipment rather than to the end products can result in a significantly different allocation to the terminated portion of the contract.

f. The contractor's accounting records may not show the engineering time spent on the contract. The contractor may, therefore, base its claim for engineering performed on estimates. A method to test the accuracy of these estimates is the "rate of effort" technique. In applying this technique, divide the contractor's total claim for engineering cost by the contractor's average staff-month wage cost for engineering to determine a comparative number of full-time engineers depicted by the contractor's claim. For example, if engineering costs claimed are $18 thousand and the contractor's average engineering wage cost is $1 thousand per staff-month, the claim would represent 18 staff-months of engineering effort. If the period between the contract date and the termination date was three months, the claim would represent the full-time services of six engineers ($18 thousand divided by $1 thousand equals 18; divided by 3 equals 6). This technique may suggest that the contractor's claim represents several times the effort that available engineering personnel were capable of performing. Whenever possible, state in the audit report whether the claimed estimate approximates the "rate of effort" required to achieve the engineering work actually performed.

12-305.3 Royalties and Other Costs for Using Patents

a. Contract terms and the FAR provisions incorporated in the contract determine the allowability of royalties, license fees, patent or license amortization costs. These costs are usually allowable if necessary for contract performance unless:

(1) the Government has a license or the rights to free use of the patent,
(2) the patent has been ruled invalid,
(3) the patent is considered to be unenforceable, or
(4) the patent has expired.

b. The contractor's right to use a patent may benefit the terminated contract only or the terminated contract and other work. Determine whether there is benefit to other work, and whether costs are properly allocated between the terminated contract and the other benefiting work. For a claim prepared on the inventory basis, determine that the cost or fee claimed is properly allocable to the terminated portion of the contract.

c. Where the agreement for patent use provides for royalties or fees only on delivered contract end items, no payments are allocable to the terminated portion of the contract.

12-305.4 Severance Pay

a. Severance pay is payment in addition to regular salaries and wages to employees whose services are being terminated. Such costs are allowable only when payment is required by:

(1) law,

(2) employer-employee agreement,

(3) established policy that is, in effect, an implied agreement on the contractor's part, or

(4) circumstance of the particular employment.

Normal severance pay relates to recurring, partial layoffs, cutbacks, and involuntary separations and is an allowable cost when properly allocated. A termination, however, may result in a significant employee layoff and the resultant severance pay amount may be substantial. FAR 31.205-6(g)(5) provides that periodic or annual accruals for abnormal or mass severance pay are not allowable, but the costs are considered on a case-by-case basis when incurred.

b. In considering the allowability and allocability of mass severance pay, determine:

(1) The impact of termination on the contractor's work force. A termination claim should not be a way to recover severance pay generated by an employee layoff resulting from other conditions.

(2) The rights of employees and whether the contractor can use the employees on other work.

(3) The Government's share of the contractor's business during the period the severance pay was earned. Employees may have earned the right to severance pay over an extended period during which the contractor's business was commercial rather than Government. Allocating total severance pay to Government work, in such a case, would not be equitable.

(4) The method by which the contractor computed severance pay and the proposed payment method. The contractor's plan may provide for severance payments over an extended period, but payments stop if the employees obtain other positions.

(5) The effect of mass severance on existing reserves for normal severance, supplemental unemployment benefits, and pension funds. Substantial credits may result from nonvested rights in pension funds or other sources which the contractor may not have considered.

c. The conditions under which terminated employees will receive severance pay vary from one contractor to another. Depending on the contractor's policy or employer-employee agreement, the contractor may tie the liability for severance pay to the supplemental unemployment benefits plan. In this event, the final liability is unknown for an extended period. When some part of mass severance pay appears allocable but the

total amount is unknown when audited, report the amount as unresolved. Furnish pertinent details and recommend that the contracting officer put an appropriate reservation in the settlement pending the subsequent determination of the actual amount (see 12-313b).

d. Exclude mass severance pay amounts from any computations made to determine whether the contractor would have suffered a loss had the contract run to completion, unless the contractor would have experienced the layoffs anyway.

12-305.5 Rental Costs Under Unexpired Leases

a. Rental costs under unexpired leases are usually allowable where supporting records show that the lease was reasonably necessary to perform the terminated contract if:

(1) the rental amount claimed does not exceed the reasonable value of the property leased for the period of the contract and any future period as may be reasonable, and

(2) the contractor makes reasonable efforts to terminate, assign, settle, or otherwise reduce the cost of the lease.

b. The cost of leased property alterations necessary to perform the contract and the cost of reasonable restoration required by the lease provisions are also allowable. Adjust unexpired lease costs by any residual value of the lease due to the termination, assignment, or settlement of the lease agreement.

c. Verify that the length of the lease was not significantly longer than the anticipated contract performance period, and that the lease cost was not significantly higher than comparable space in the same general area. FAR 31.205-36(b) limits lease costs between organizations under common control to the normal ownership costs such as depreciation, taxes, insurance, and maintenance.

d. Where a terminated contract effects only a part of the effort at a leased facility, the contractor might submit a claim because other work will now have to absorb lease cost otherwise absorbed by the terminated contract had it run to completion. In this case, determine whether the contractor leased the space due to receiving the contract now terminated, or if the contractor leased the facility before receiving the contract. If the former condition exists, the allocable portion of the cost may be acceptable if it otherwise meets the above criteria. If the latter is true, the premises are a part of the contractor's normal plant facilities and no amount for unexpired rental cost would be acceptable.

12-305.6 Travel Costs

Reasonable travel costs allocable to the terminated portion of the contract are allowable. When a settlement proposal includes travel costs, determine whether they benefit the entire contract or only items completed and delivered. For example, if travel cost relates directly to installing or interfacing end items, no travel cost would be allocable to the terminated portion of the contract. Normally the auditor would question any amount so claimed. Reasonable travel costs incurred in termination activities are settlement expenses. If included as Other Costs, reclassify them.

12-305.7 Costs Continuing After Termination

a. Costs continuing after the effective termination date due to the contractor's negligent or willful failure to discontinue them are unallowable. The effective termination date is the date the termination notice first requires the contractor to stop performance, or the date the contractor receives the notice, if the contractor receives the termination notice after the date fixed for termination.

(1) Reasonable costs associated with termination activities are allowable. FAR 31.205-42(b) recognizes there may be instances where costs incurred after termination may be allowable. For example, the contractor may have contract personnel at a remote or foreign location or there may be personnel in transit to or from these sites. The cost of their salaries or wages would be allocable to the terminated contract for a reasonable period required to transfer the personnel to sites for termination or use on the contractor's other work. In another example, components or end items may be in a heat-treating or electroplating process when termination occurs and the contractor may elect to complete rather than disrupt the process and risk complete loss of the items.

(2) In cases such as the above example, make sure that the contractor's decision did not increase the Government's costs. Also make sure these costs (i) are classified as costs of contract performance rather than settlement expenses (see 12-305(c)), and (ii) do not represent efforts by the contractor to convert raw materials and purchased parts to work-in-process, or to convert work-in-process to finished items solely to advance the completion stage to increase costs and/or profit recoverable by the claim.

(3) After receiving the termination notice, the prime contractor may decide not to immediately terminate its subcontracts. The prime may first have to determine the scope of the termination, review the completion stage of subcontracts, and determine requirements on other contracts to consider diverting components to other work. This may take time during which subcontractors are continuing to work. Overall, however, the efforts of the prime contractor may result in subcontract claims far less than would otherwise have occurred. Work closely with knowledgeable technical personnel when reviewing the reasons why the prime contractor failed to immediately terminate its subcontracts.

(4) Floor checks and plant perambulations performed immediately following a contract termination in the physical area(s) affected will usually show whether the contractor is taking necessary steps to stop work and to divert personnel to other assignments. Where appropriate, request technical help from Government personnel familiar with the production areas and processes.

b. Question amounts claimed as unabsorbed overhead, under whatever name, representing expected overhead or parts of it absorbed by the contract if not terminated (see FAR 31.205-42).

The Armed Services Board of Contract Appeals (ASBCA) has issued decisions stating that post-termination unabsorbed overhead is not recoverable in a termination claim. In Technology, Inc., ASBCA No. 14083, 71-2 BCA 8956 and 72-1 BCA 9281, the Board held that unabsorbed overhead relates to the contractor's existence as an ongoing organization and is not a continuing cost of a terminated contract. Further, the Government is not a guarantor of the contractor's continuing overhead nor is this intended by the language in the termination clause. In Chamberlain Manufacturing Corp., ASBCA No. 16877, 73-2 BCA 10,139, the Board affirmed the previous decision using similar reasoning. The Board stated further that a loss of business, whether in the guise of post-termination G&A expense or otherwise,

is not recoverable in a termination claim. The decision also reads that the continuing costs to which FAR 31.205-42 refers clearly are only those costs directly related to the terminated contract and if the drafters of the regulation had intended to allow unabsorbed overhead they could have done so simply and clearly as they did for rental costs.

c. While unabsorbed overhead is not allowable as part of a termination settlement, it may be appropriate for an equitable adjustment resulting from a partial termination.

12-306 Auditing General and Administrative Expenses

a. Determine whether:
(1) the individual items in the G&A pool are allowable,
(2) the allocation base is equitable, and
(3) the amount allocated to the termination claim is reasonable.

In auditing this area, use the appropriate FAR Part 31 cost principles, and the audit guidance in 6-600.

b. Including the subcontract settlement amounts in the allocation base for G&A is acceptable if including them otherwise satisfies the allocability criteria in FAR 31.201-4, 31.203, and 31.205-42(h).

c. Contractors often direct charge G&A type expenses as part of settlement expenses in addition to the G&A allocated to the rest of the claim. When the contractor uses this procedure, ensure that any G&A allocated to the rest of the claim does not include costs charged directly as settlement expenses and that these direct charges are excluded from the G&A allocated to continuing contracts. As an alternate procedure, the contractor may choose to recover G&A type settlement expenses by applying normal G&A. This procedure is acceptable provided the method does not result in an inequitable allocation to other contracts (also see 12-309).

d. Sometimes applying a full G&A expense rate to the amounts included in a termination claim is not appropriate. The contractor should limit developing a special (less than full) G&A rate to those rare situations where the termination inventory is significant and its cost pattern is clearly different from that of any other contracts or work segments in the normal allocation base. For example, a contractor's normal allocation base for G&A expenses may be cost input, but the settlement proposal includes only unprocessed material costs. In this case, it may be appropriate to develop a special G&A expense rate based on eliminating from the expense pool those items which relate exclusively to labor, overhead, and finished items.

12-307 Evaluating Profit or Loss

a. Profit is allowed for preparations made and work done by the contractor on the terminated portion of the contract. Profit is not allowed (1) on work not performed due to the termination, (2) subcontract material and services that have not been delivered to the prime contractor as of the effective date of the termination, or (3) settlement expenses. The contracting officer will consider the contractor's settlement efforts and the character and difficulty of subcontracting in arriving at a profit objective (see FAR 49.202).

(1) The auditor should determine whether a terminated contract would have resulted in a loss if it had gone to completion. Determining this is important because (a) no profit is allowable if it appears that the contractor would have incurred a loss had the contract been

completed, and (b) termination claims are reduced by an amount equal to the pro rata share of any reduced profit that would have occurred had the contract been completed.

(2) An auditor can usually determine the anticipated profit rate with reasonable accuracy if the contract was substantially complete at the time of termination. For a partial termination, if cost information is available on the continued portion of the contract, determine the anticipated profit rate. Request the contractor, through the contracting officer, to furnish an estimate of the cost required to complete the terminated portion of the contract. Review the estimate with necessary help from technical representatives (see 12-302g). The contractor's estimate to complete may be conservative and show that no loss would have occurred. Make a concerted effort to evaluate the contractor's projected profit.

(3) There is no contractual requirement for the contractor to furnish an estimate to complete. If the contractor declines to submit an estimate to complete or states that a cursory review found that no loss would have occurred, technical personnel with auditor assistance can prepare the estimate to complete. Developing data that shows a loss in this situation may place the burden on the contractor to submit data regarding its profit or loss position.

b. When evaluating a contractor's projected profit rate, consider what allowable costs would have been incurred without the termination. In cases where common items may have been diverted from the terminated portion of a contract to the contractor's other work or if the contractor has not claimed all costs that would be allowable under a contract, include them in projections of costs to complete the contract.

c. Where there is no reasonable basis for the contractor to determine the profit rate had the contract gone to completion or the auditor cannot make a realistic evaluation of the contractor's projection, include in the audit report information and comments that may prove helpful to the negotiator. This might include comments such as:

(1) the profit rate realized on the end products completed to date of termination,

(2) the contractor's average experienced profit rate on similar products,

(3) the profit rate both parties intended when the contract was negotiated, and

(4) the profit amount the contractor would receive under a formula settlement if the contract termination clause provides for its use.

d. Quantitative methods are useful tools when auditing termination settlement proposals. For example, applying statistical sampling to inventory costing or to incurred costs can save considerable time. Also, an understanding of improvement (learning) curve techniques (see EZ-Quant) is essential, particularly when evaluating contractors' and subcontractors' estimates to complete the contract. While most auditors normally associate using an improvement curve with evaluating direct labor hour estimates, auditors may also use it in evaluating the estimated prices of direct material parts and components. Factors considered when evaluating the cost estimate to complete include:

(1) cost experience data available before the Government terminated the contract,

(2) directly applicable experience for an entire product line previously produced, or

(3) other similar experience from other products or components.

When applying improvement curve techniques, follow the audit guidance in EZ-Quant.

12-308 Adjusting for Loss Contracts

a. For terminated "loss" contracts, FAR 49.203(b) and (c) state the methods for determining the maximum to be paid on inventory and total cost settlements. Fundamentally, these

methods are intended to adjust the contractor's termination claim. The Government does this by applying to the amount claimed a percentage calculated using the total contract price compared to the total estimated cost incurred had the contract been completed. The following examples illustrate the loss adjustment under the inventory basis and the total cost basis.

(1) Assume a termination having the following conditions:			
Total contract price (50 units @ $2,400 each)			$120,000
Total amount invoiced for completed units (35 units @ $2,400 each)			$84,000
Total costs incurred under the contract			$135,000
Settlement with subcontractor			5,000
Estimate of cost to complete contract ($10,000 + subcontract - settled for $5,000)			$ 15,000
Settlement expenses			$ 1,000
Disposal credits			$ 5,000
Units completed and delivered prior to termination			35
Units completed and on hand and not to be delivered			5
Units terminated			10
(2) Assume also that the contractor submitted a settlement proposal on the inventory basis as follows:			
Finished components	$7,000		
Work in progress	3,250		
Dies, jigs, fixtures, and special tools	2,000		
General and administrative expenses	1,000		
Other costs	3,000	$16,250	
Profit		2,000	
Settlement expenses		1,000	
Settlements with subcontractors		5,000	
Acceptable finished product (adjusted for freight and packaging savings)		11,000	
Less disposal credit		(5,000)	
Net payment requested		$30,250	
The amount recommended for settlement, assuming all claimed costs are otherwise acceptable, would be computed as follows based on FAR 49.203:			
Settlement expenses		$ 1,000	
Contract price, as adjusted, for acceptable completed end item		11,000	
Total settlement amount otherwise agreed to or determined, adjusted for estimated loss		17,000*	
Less disposal credit		(5,000)	
Recommended settlement amount		$24,000	

*Computed by multiplying the sum of the contractor's own costs of $16,250 plus settlements with subcontractors of $5,000 by the ratio of the total contract price of $120,000 to the total indicated cost of $150,000. Total indicated cost is composed of the total cost of $135,000 incurred prior to termination plus the estimated cost of $15,000 to complete the entire contract:

$$\$21,250 \text{ X } \frac{\$120,000}{\$150,000} \text{ or } \$21,250 \text{ X } 80\% = \$17,000$$

(3) Assume that the contractor submitted a proposal on the total cost basis as follows:			
Direct material	$24,000		
Direct labor	30,000		
Indirect factory expense	50,000		
Dies, jigs, fixtures, and special tools	10,000		
Other costs	15,000		
General and administrative expenses	6,000	$135,000	
Less finished product invoiced or to be invoiced		(84,000)	$51,000
Profit			0
Settlement expenses			1,000
Settlement with subcontractors			5,000
Disposal and other credits			(5,000)
Advance, progress and partial payments			(0)
Net payment requested			$52.000
The amount recommended for settlement, assuming all claimed costs are otherwise acceptable, would be computed as follows based on FAR 49.203:			
Settlement expenses			$ 1,000
The total settlement amount otherwise agreed to or determined, adjusted for estimated loss			112,000
Less disposal credit			(5,000)
Less amount previously paid contractor			(84,000)
Recommended settlement amount			$ 24,000

[1] No claim for profit made by contractor because the contract price has been exceeded.

[2] Computed by multiplying the sum of the contractor's own costs of $135,000 plus settlements with subcontractors of $5,000 by the ratio of the total contract price of $120,000 to the total indicated costs of $150,000. Total indicated cost is composed of the total costs of $135,000 incurred prior to termination plus the estimated cost of $15,000 to complete the entire contract:

$$\$140{,}000 \text{ X } \frac{\$120{,}000}{\$150{,}000} \text{ or } \$140{,}000 \text{ X } 80\% = \$112{,}000$$

b. When there are unpriced changes existing at the time of the audit, inform the contracting officer that the loss adjustment is tentative and will require recomputation if the changes result in upward or downward revisions of the total contract price. Similarly, where the contractor uses estimates for subcontract settlement amounts, advise the contracting officer that the loss adjustment will require recomputation if negotiated settlements differ from the estimated amounts.

12-309 Auditing Termination Settlement Expenses

a. For ease in settling a termination proposal, the contractor should establish a separate job order or code to which settlement expenses can be directly charged. Allowable settlement expenses in a termination claim, listed in FAR 31.205-42(g), may include but are not limited to the following:

(1) Accounting, legal, clerical, and similar costs reasonably necessary for the preparation and presentation of settlement claims and supporting data and for the termination and settlement of subcontracts.

(2) Reasonable costs for the storage, transportation, protection, and disposition of property and inventory acquired or produced for the contract.

b. Methods of accumulating settlement expenses vary. Contractors may charge only for the costs of direct labor and material expended, or the labor charges may include an amount for related overhead costs such as supervision, space, fringe benefits, and other costs. When a contractor has established a special termination department, all direct costs on termination activities may be accumulated and overhead burden added to cover other costs of the termination department. Costs may then be equitably distributed to specific settlements. Auditing settlement expenses requires a decision on the accuracy, reliability, and reasonableness of the claimed amounts. Audit procedures outlined for examining the contractor's other costs equally apply to verifying settlement expenses.

c. When the contractor accounts for settlement expenses as direct charges, it should maintain labor time cards and distribute labor costs to the terminated work. Confirm that the contractor has not assigned highly paid personnel to routine work. When possible, contractor's employee time records covering settlement activities should describe the particular work performed. Perform tests to ensure that indirect allocations do not duplicate other claimed costs.

d. FAR 31.205-42(g)(1)(iii) lists some of the indirect costs applicable to termination efforts. These are normally limited to those types of costs that are applied to indirect labor. However, a full burden of indirect costs is appropriate when the contractor’s established practice is to charge such labor effort direct to contracts. This concept is also applicable to termination efforts that are not specifically listed in FAR 31.205-42; i.e., the application of indirect costs should be consistent with the established practice for any effort that would have been charged direct had the effort been incurred under ongoing contracts. When termination functions include costs which are usually charged direct and are included in the G&A base in accordance with the contractor’s established accounting practices, it would be appropriate to allocate normal overhead and G&A to the termination settlement expenses. In contrast, when a contractor’s usual practice is to charge the types of costs included in termination functions to G&A, it would be inappropriate to allocate G&A to such expenses because they are not a part of the G&A base.

e. When the contractor improperly burdens termination effort, the auditor should question the improper burden on the basis of allocability. In addition, if the contractor burdens termination effort differently based solely on the status of the submission (proposal versus claim), the auditor should cite the contractor for noncompliance with CAS 402.

f. Determine whether personnel compensation cost directly included in the settlement expenses reasonably relates to the time required for termination activities. This is particularly important when settlement expenses include the time of officers and executive personnel. The contractor should normally have records to support the amounts claimed.

g. When the contractor identifies and charges settlement expenses directly to termination claims, the contractor should absorb settlement expenses applicable to no-cost settlements.

h. Question costs beyond those considered reasonably appropriate for the termination settlement such as for unnecessary work, unrealistic professional fees, etc. Where the auditor cannot resolve the reasonableness of an amount, refer the amount to the contracting officer as unresolved cost, furnishing factual information and comments which may be useful to the contracting officer in deciding if the costs are acceptable (see 12-313b).

i. A contractor may decide to obtain professional accounting services to help settlement proceedings. Reasonable costs of these services, including preparing the settlement proposal, may be reimbursed to the contractor. Evaluate the reasonableness of accounting service charges by considering the complexity of the proposal compared to the number of staff-days represented by the fee amount.

j. Where the contractor claims legal expenses, evaluate their reasonableness considering the time charged, the nature of the services provided, and the relationship of the legal expenses to the total termination settlement amount. Include appropriate comments in the report. For contingent fee arrangements, i.e. where the legal fee is based on the negotiated settlement amount, clearly describe this arrangement in the report.

k. Settlement expenses may include reasonable storage costs incurred in protecting termination inventory, but these are allowable as settlement expenses only during the plant clearance period as defined in FAR 45.601. Allowable storage costs should not exceed the cost that would normally be incurred to care for and protect the inventory and should represent an equitable allocation of the contractor's total storage costs. As discussed in FAR 45.612-2, 45.612-3, and DFARS 245.612-3, when a contractor stores termination inventory in a special warehouse or other special storage location, on or off its own premises, it must absorb the additional (above normal) storage expense, including any related removal expenses. This is unless the contracting officer has determined that such removal or storage is for the convenience of the Government. Undue delay by the contractor in submitting acceptable inventory schedules or prolonging the plant clearance period should not increase storage charges to the Government. Following the plant clearance period, the contractor may request the contracting officer to remove the inventory items, or to enter into a separate storage agreement covering them.

l. As noted above, settlement costs may include, as a direct charge to the termination settlement, costs the contractor has disclosed or established as indirect costs. At contractors where there is continuing auditable work ensure that the contractor credits expense pools for the costs allowed as a part of settlement expenses before developing rates to be applied to other contract effort.

m. When a termination settlement proposal becomes a Contract Disputes Act claim (see 12-101i), legal and consultants' costs incurred in the prosecution of the claim are unallowable. Refer to 12-606 for guidance. However, legal and consultants' costs reasonably necessary to prepare and support a termination settlement proposal for negotiation (discussed in a.(1) above) are generally allowable as contract administration function costs (see FAR 31.205-42(g)).

12-310 Auditing Subcontractor Settlements

a. Termination settlements with subcontractors follow, in general, the principles on prime contract settlements. A subcontractor does not have contractual rights against the Government when its subcontract is terminated. A subcontractor's rights are against the prime contractor or higher-tier subcontractor with which it has contracted. The prime contractor and each subcontractor is responsible for settling termination proposals of its immediate subcontractors based upon the contract terms and applicable regulations (see also 12-204).

b. When DCAA did not perform the audit of a subcontractor's termination claim, the auditor at the prime location will evaluate the review done by the prime contractor. The auditor should particularly evaluate, on a selective basis, settlements made by the contractor

without contracting officer approval or ratification using the authority granted to the contractor under FAR 49.108-4. The auditor should have available the prime contractor's complete case file. The file should contain, as a minimum, a complete copy of the subcontract; a copy of the subcontractor's settlement proposal, with any amendments or revisions; audit and technical evaluations; minutes of all settlement negotiations; and related correspondence.

c. Where deficiencies exist, discuss them with the contractor and explain them in the report issued on the prime contract termination settlement proposal. If additional independent verification is required, send a request for an assist audit to the cognizant auditor. The request should fully explain the areas of apparent deficiencies to prevent duplication of effort. Call the contracting officer's attention to any pattern of settlements which appear questionable or which suggest that the contracting officer should restrict or withdraw settlement authority granted.

d. The Government and subcontractors can make direct settlements under unusual circumstances by having the prime contractor assign the subcontract to the Government. The standard prime contract termination clause allows subcontract assignment. Direct settlements with subcontractors, however, are only done when the contracting officer determines that they are in the best interest of the Government.

12-311 Auditing Disposal and Other Credits

Credit amounts included in a settlement proposal normally represent:

(1) an offer by the contractor to purchase inventory at less than cost,
(2) the proceeds from the sale of termination inventory, or
(3) a combination of (1) and (2).

A contractor's offer to purchase inventory at less than cost is subject to review by plant clearance personnel and to negotiation between the contractor and the contracting officer. When the offer is to purchase for a percentage of cost, verify that the contractor has considered the full cost of the material including any applicable labor and burden rather than just the purchase cost of the material. Also verify that the contractor made all sales of termination inventory at prices not less than those approved by the plant clearance officer (FAR 45.610).

12-312 Auditing Advance, Progress, or Partial Payments

a. Advance, progress, and partial payments are amounts paid to the contractor before, during or after contract performance/termination. The amounts do not represent payments for completed items invoiced at the contract price. Any unliquidated amounts paid to the contractor under advance, progress, or partial payments must be offset against the final settlement proposal. Final accounting for all advance, progress, and partial payments is part of the final settlement and is verified by the finance or disbursing officer before final payment. The audit report should note any inaccuracies in the amount reported by the contractor to prevent unnecessary complications in the final accounting for termination payments.

b. The contracting officer may request an audit of interim settlement proposals submitted to support requests for partial payments on terminated contracts. The auditor should honor these requests. However, since an audit will typically be performed on the final settlement proposal, an examination of interim proposals usually need not be done. Make

sure that the claimed costs have been incurred and that the accumulated partial payment amount does not exceed the total amount the contractor is expected to receive in final settlement of the termination claim.

12-313 Format, Content, and Distribution of Audit Reports

a. Use the guidance in 10-700 for preparing and issuing audit reports on termination settlement proposals.

b. Use the criteria and guidance in 10-304.8 in determining questioned costs. Section 10-304.8 provides the criteria for unresolved costs. However, because of the particular nature of termination actions, the unresolved costs category is extended to include amounts applicable to those types of items on which the auditor is unable to reach a conclusion because the contractor's net cost or liability will not be firmly established until a later date. Examples of these items are severance pay and the cost of unexpired leases.

12-400 Section 4 --- Auditing Terminations of Cost-Type Contracts

12-401 Introduction

a. The purpose of this section is to furnish guidance for auditing terminated cost-type contracts.

b. The contract cost principles relevant to the contract involved still govern the allowability of costs if the contract is terminated. Under terminated cost-type contracts, the contractor has various options for claiming costs after the termination date. Paragraphs 12-402 and 12-404 below discuss these options. These paragraphs also advise whether only a final voucher evaluation memorandum is necessary or whether a final voucher evaluation memorandum and an audit report are required.

12-402 Options Available

a. When the Government has completely terminated a cost-type contract, the contractor is given the option of either vouchering out costs incurred both before and after the contract termination date (continuing to request reimbursement for incurred costs on standard public voucher forms) or submitting a settlement proposal. The Government limits the option to voucher out costs to six months, after which the contractor must claim unvouchered costs associated with the terminated contract on Standard Form (SF) 1437, Settlement Proposal for Cost-Reimbursement Type Contracts. The contractor's exercise of its option to claim costs on SF 1437 is irrevocable. Once selected, all unvouchered costs must be submitted on the settlement proposal form. The last voucher submitted under the vouchering out procedure is considered the "completion voucher." The contractor should specifically identify it as such, even though there may be unvouchered costs which the contractor plans to submit in the settlement proposal. Process this voucher as set forth in 10-900. The contractor must submit its proposal to determine the final fee amount under the contract by letter or by SF 1437.

b. When the Government partially terminates a cost-type contract, FAR 49.304 limits with certain minor exceptions, the settlement to a fee adjustment, if any. The contractor shall submit a settlement proposal covering this adjustment. The contractor shall continue to submit an SF 1034 (“Cost Voucher” in Wide Area Workflow) for all reimbursable costs requested under the contract (see 12-402.1a), including:

(1) its own costs allocable to the terminated portion of the contract,
(2) settlement costs for subcontractors, and
(3) applicable settlement expenses.

c. Normally, a selection to voucher out means the auditor will issue a contract audit closing statement (using the guidance in 10-900) once he or she has completed the audit. A selection to submit a settlement proposal usually means the auditor will also issue an audit report (in addition to the closing statement) using the guidance in 10-700. Further comments on this are in 12-404.

12-402.1 Costs and Fee Vouchered Out

a. When the contractor decides to continue vouchering out, it submits contract costs in the usual manner on Standard Form 1034 (“Cost Voucher” in Wide Area Workflow). Costs submitted on vouchers may include all contract costs, including settlement expenses and settlements with subcontractors. For terminated contracts under the cognizance of DLA,

contractors must submit separate properly identified vouchers for subcontract settlements and for settlement expenses. Such contractors must also submit all subcontract termination settlements to the TCO for prior approval and ratification, except those settlements under FAR 49.108-4. The contractor must furnish evidence of the approval with the SF 1034 voucher ("Cost Voucher" in Wide Area Workflow). When the contractor has vouchered out all costs within the six month period, it may submit its claim for fee, if any, on SF 1437 or by letter appropriately certified.

b. Disapprove costs submitted on SF 1034 ("Cost Voucher" in Wide Area Workflow) that are similar to those covered by a GAO formal exception or presented on a "reclaim voucher."

12-402.2 Costs and Fee Submitted in a Settlement Proposal

The contractor should submit settlement proposals to the contracting officer within 1 year from the effective termination date unless contract terms or agreement extends the period. The auditor's function in auditing the settlement proposal is advisory and is primarily to help the contracting officer negotiate an equitable settlement. Perform the audit of costs included in the settlement proposal under a cost-type contract using the guidance contained in Chapter 6 and 12-300, as appropriate. Verify that the contractor has excluded previously reimbursed costs from the proposal. When the contractor includes costs previously disapproved by a DCAA Form 1, or costs disapproved under a GAO exception (or are of a similar nature), question the amount. When the settlement proposal covers a contract termination for default, question costs incurred in preparing the proposal.

12-403 Fee

a. The termination clause of the contract governs the adjusted fee, unless there are other contract clauses that exempt the determination of the fee from the clause. The adjusted fee shall be based on the percentage of completion of the contract, but should not include an allowance for fee for subcontract effort included in subcontractors' settlement proposals (FAR 49.305-1). In determining the contract completion percentage, the Government gives consideration to the work done by the contractor in handling the termination notice, settling subcontractors' claims, and disposing of the termination inventory. To help the contracting officer adjust the fee, provide comments on the total estimated cost to complete the contract. Also provide comments on the relationship between the physical percentage of completion and the percentage of costs incurred to the total estimated cost of performing the contract. The auditor should also comment if the contractor incorrectly applied fee to subcontract costs.

b. When specific contract provisions exempt the determination of the fee from the termination clause, the provisions of such clauses govern. For example, a cost-plus-award fee contract usually specifies that the amount of the fee is determined by the fee determining official (FDO). Accordingly, the provisions of the award fee clause should govern how the award fee amount is determined, not the provisions provided in the Termination (Cost Reimbursement) clauses (FAR 52.249-6) of the contract. For all types of cost-reimbursable contracts, review the contract for specific fee payment arrangements and provide comments to the contracting officer on any relevant cost and/or fee data.

12-404 Contract Audit Closing Statements on Vouchered Costs and Fee

Auditors must prepare a contract audit closing statement or final audit report, showing the costs and fee billed on public vouchers (Standard Form 1034) for each terminated cost-type contract. Follow the procedures contained in Chapters 6 and 10 to prepare and distribute contract audit closing statements. Closing statements should address:

(1) any disapproved costs the contractor intends to appeal,
(2) the fixed fee amount paid through the last voucher, and
(3) whether the fee is subject to a final settlement adjustment.

When all costs incurred under the terminated contract have been vouchered out, the contractor should submit all enclosures that regularly accompany contract audit closing statements. Also follow this procedure when the contractor has stopped using vouchers and the settlement proposal includes other unvouchered costs, except the "Assignment of Refunds, Rebates and Other Credits" is not required. The Government will incorporate this document into the settlement agreement after negotiations.

12-405 Terminated Cost-Type Subcontracts

A prime contractor or upper-tier subcontractor may terminate cost-type subcontracts. Termination may be for convenience of the Government or for default. Audit concerns for a terminated subcontract are similar to a terminated prime contract. When auditing subcontract settlement proposals, follow the guidance provided for auditing terminated prime contracts. Unless the auditor receives a specific request through Government channels, he or she should not normally audit and report on settlement proposals prepared by subcontractors since this is a prime contractor responsibility. Be alert, however, to situations where an audit may be desirable and where the interested procurement activity should be informed (see 12-204 and 12-406).

12-406 Termination of Subcontracts for the Convenience of the Contractor Under Cost-Type Contracts

The contractor or the Government may find it necessary to adopt changes in the manufacturing or engineering effort or in material requirements while performing a cost-type contract. After receiving a contract change, the prime or upper-tier subcontractor must terminate orders or subcontracts that become unnecessary due to the contract change. The contractor should carry this out by using the termination clause in the subcontract. It should base settlements on the cost principles incorporated in the terminated subcontract. In some instances, the Government may allow an equitable adjustment of the prime contract price under the changes clause in the contract. The auditor of the prime contractor involved in such adjustments is responsible for ensuring that subcontracts terminated under these circumstances are settled in the Government's interest since the settlement amount becomes part of the prime contractor's claim for an equitable adjustment. The auditor should therefore establish a means for the contractor to notify the audit activity of such subcontract terminations. When a terminated subcontract settlement appears to have been based on inadequate review by the prime contractor, the DCAA auditor at the prime or upper-tier subcontractor should request an audit of the subcontractor's termination proposal.

12-407 Expediting Indirect Costs Settlement

a. Final settlement of a terminated cost-type contract may be unduly delayed if settlement is withheld until indirect cost rates are established using FAR 42.705 for the final period in which the contract was performed. To prevent these delays, FAR 49.303-4(a) permits the contracting officer, after receiving the audit recommendations, to negotiate an indirect cost amount for the final period of contract performance and thus promptly produce a final settlement of the contract (see 6-711.2).

b. Normally, the auditor provides final determined indirect cost rates for the entire contract performance period. If prompt final determination is not possible, authority to expedite indirect cost settlement and contract close out is discussed in 6-711.1 and 6-1010. As a further factor, note that FAR 49.303-4(b) requires the contractor to prepare its indirect cost proposal for other contracts completed during the period by eliminating from the total pools and allocation bases the corresponding indirect costs and related direct costs applied to the terminated contract.

12-408 Impact of Limitation of Cost or Funds Clause on Termination Settlements

a. When a contract that includes the Limitation of Cost (FAR 52.232-20) or Limitation of Funds (FAR 52.232-22) clause is terminated, the contractor's recovery of settlement proposal costs (proposed contract costs plus proposed settlement expenses) may be limited because of the total amount allotted by the Government to the contract. Allowable and reasonable settlement expenses are subject to the Limitation of Cost or Funds clause. Refer to 12-309 for guidance on the audit of settlement expenses.

b. Under FAR 52.232-20 and 52.232-22, the Government is not obligated to reimburse the contractor for costs incurred in excess of cost or funding limitations. Similarly, the contractor is not obligated to continue performance under the contract or otherwise incur costs in excess of the limitation or, if the contract is cost sharing, the amount then allotted by the Government to the contract plus the contractor's corresponding share. Refer to 11-102 for further details.

c. To determine questioned costs under a termination settlement proposal, the auditor should:

(1) Evaluate the settlement proposal costs (proposed contract costs plus proposed settlement expenses) per 12-309 and 12-401 - 406. Question any unallowable costs.

(2) Quantify the allowable proposed contract costs and the allowable settlement expenses.

(3) Determine prior allowable contract costs not included in the termination settlement proposal.

(4) Add the allowable proposed contract costs and settlement expenses (Step 2) and prior allowable contract costs (Step 3) to determine the total allowable costs.

(5) Ascertain the total amount of funds allotted to the contract including any revisions to the original contract funding.

(6) Compare the total allowable costs (Step 4) to the total funds allotted to the contract (Step 5). Question any allowable costs that exceed the funding limitation.

(7) Total questioned costs are the sum of unallowable proposed contract costs and unallowable settlement expenses (Step 1) and costs in excess of the funding limitation (Step 6).

12-500 Section 5 --- Price Adjustment and Contract Settlement Proposals or Claims - Overview

12-501 Introduction

This section provides general information and guidance for auditing contractor price adjustment and contract settlement proposals or claims.

12-502 Price Adjustments and Contract Settlements

a. Equitable adjustments are a large subset of the universe of price and settlement actions. Equitable price adjustments result from changes made by the Contracting Officer that are within the general scope of the contract. When changes made within the general scope of the contract cause an increase or decrease in the contractor's costs or the period of performance, there is an equitable adjustment in the contract price including costs and profit and the contract is modified. Requests for equitable adjustment submissions include both proposals and claims (see 12-504(b)).

b. Delay/disruption represents a unique type of equitable adjustment. Delay/disruption proposals or claims are requests to recoup costs as a result of Government caused delay/disruption. Depending upon the type of contract and the circumstances underlying the delay/disruption, such requests may be made under FAR 52.243 (standard change clauses), FAR 52.242-15 (stop-work order clause for supply and service contracts), or 52.236-2 (differing site conditions for fixed price construction and demolition contracts). However, adjustments under the suspension of work clause for construction contracts (FAR 52.242-14), and the Government delay clause (FAR 52.242-17) do not include profit and therefore are not equitable adjustments. Auditors should contact the CO to determine the clause under which the claim was submitted.

c. A termination for convenience settlement proposal is a contract settlement action under a termination clause. A termination settlement proposal is a contractor’s submission for costs incurred because the Government terminated or partially terminated the contract for convenience. A termination settlement agreement amends the contract to incorporate all mutually agreed upon terms arising from negotiation of a settlement proposal. However, in the case of a partial termination for convenience, the contractor is authorized to request an equitable adjustment in the prices of the undelivered unterminated items of the contract. While a request for equitable adjustment may be submitted as a result of a partial termination, it is a separate action from the termination settlement proposal. The request for equitable adjustment is subject to the same requirements, including certification requirements, as equitable adjustment proposals or claims submitted in other circumstances. Refer to 12-100 for further guidance on termination for convenience settlement proposals.

d. Extraordinary relief requests represent contract price adjustments submitted pursuant to the provisions of 50 U.S.C. 1431-1435. (See 12-900)

12-503 Audit Adequacy of Proposals or Claims

Determine whether proposals or claims are adequate for audit (i.e., submitted in substantially the same format and containing the same data as required in FAR 15.408, Table 15-2; compliant with applicable regulatory and contractual requirements) before beginning

the audit. Immediately notify the contracting officer of inadequate proposals or claims to facilitate the decision on acceptability. The written notification should describe the specific inadequacies, the cost impact of the inadequacies, and the data needed to correct the deficiencies. If, after FAO Manager and/or RAM involvement with contract administration management, the contracting officer insists that an audit be performed on the inadequate proposal or claim, confirm this in writing and advise the contracting officer that an audit cannot be performed on unsupported items, and, as a result, all unsupported items will be questioned and an adverse audit opinion will be expressed on the proposal or claim. Use the checklist provided in the standard audit programs for delay claims and equitable adjustment proposals or claims to determine if the proposal or claim is adequate for audit. The following are some items to consider when determining adequacy of a proposal or claim.

a. When a price adjustment proposal or claim applies to work completed or substantially complete, allowable costs should be determined based on actual cost data reflected in the accounting and performance records.

b. While circumstances may require judgmental estimates, contractors must fully disclose all data used to prepare estimates, including any cost data that is factual and verifiable. In the case of a contractor that was not required to have a suitable cost accounting system because the contract was awarded based on price competition, obtain, at a minimum, a summary of the requested price adjustments and provide specific reference to the source accounting documents.

c. Certified cost or pricing data is required when price adjustment proposals exceed the FAR 15.403-4(a)(1) threshold ($700,000) unless it meets one of the exceptions in FAR 15.403-1. The CO may also require that the proposal include the certified cost or pricing data in the format indicated in Table 15-2 of FAR 15.408. In such circumstances, contractors are required to comply with the supporting documentation requirements of Table 15-2. If contractor proposals exceeding the thresholds do not include certified cost or pricing data in the Table 15-2 format, they are considered inadequate for audit. Coordinate with the requestor or the contractor to obtain the data in the Table 15-2 format. If the certified cost or pricing data is not then provided in the Table 15-2 format, the proposal should be returned.

d. For claims, and for price adjustment proposals certified when cost or pricing data are not required, the contractor is not required to provide data in the Table 15-2 format. However, the contractor is required to certify that the supporting data included in the claim is accurate and complete (see 12-505(a)). To be complete (and adequate for audit), the data must be in substantially the same format as the supporting data required in FAR 15-408, Table 15-2. If contractor claims or proposals do not include supporting data in a format that is substantially the same as that required in Table 15-2, they are considered inadequate for audit. Coordinate promptly with the requestor or the contractor to obtain the necessary data. If timely and complete data is not obtained, the claim or proposal should be returned to the contracting officer with a request that the contractor provide the necessary support so that the audit can proceed. If the contracting officer insists that the audit be performed on the inadequate claim or proposal, follow the guidance in the lead-in paragraph to this section.

e. Amounts requested in a claim could be unsupported because the underlying accounting records were not provided to the auditor. When contracts contain the Audit and Records--Sealed Bidding clause, FAR 52.214-26, or the Audit and Records--

Negotiation clause, FAR 52.215-2, contractors are required to make available to the Government all records that relate to the "litigation or the settlement of claims."

f. If a contractor appeals a contracting officer's decision on a claim to the appropriate Board of Contract Appeals or the Court of Federal Claims, the trial attorney may request an audit of the claim prior to a hearing before the organization. Under these circumstances, the rules of the Board of Contract Appeals or the Court of Federal Claims for obtaining evidence (contractor records) may take precedence. Prior to a hearing, "discovery," the procedures for exchanging information related to the claim between both parties (the contractor and the Government), may be voluntary or mandatory. Coordinate with the trial attorney to obtain data necessary to perform the audit.

g. In all instances, question costs in claims that are unsupported due to lack of access to records. Also question amounts in proposals that are not supported because the contractor has not provided access to the underlying accounting records (refer to 1-504.6a Impact of Contractor Denial of Access).

12-504 Contract Disputes Act

a. The Contract Disputes Act (CDA) of 1978 (41 U.S.C. 601-613), effective March 1, 1979, provides a comprehensive statutory procedure for resolving claims. FAR 52.233-1 provides the definition of a CDA claim. FAR Part 33 provides the policies and procedures for processing contract disputes and appeals under the CDA. A valid CDA claim, as defined in FAR 52.233-1, requires three elements: (1) a written demand or assertion by one of the parties (2) seeking as a matter of right (3) payment of money in a sum certain, an adjustment or interpretation of the contract terms, or other relief arising under or relating to the contract. All CDA claims exceeding $100,000, including those submitted for alternate dispute resolution (ADR), must be certified per FAR 33.207 (see 12-505). The CDA requires that all claims against the Government be first submitted to the contracting officer (CO) for decision. A contractor may appeal the CO's decision on the claim to an agency board of contract appeals or the Court of Federal Claims. The decision of an agency board of contract appeals or the Court of Federal Claims can be appealed to the U.S. Court of Appeals for the Federal Circuit. By mutual consent, the Contracting Officer and the contractor may agree to use ADR. ADR is defined in FAR 33.201 as "any type of procedure or combination of procedures voluntarily used to resolve issues in controversy." FAR 33.201 further provides that "these procedures may include, but are not limited to, conciliation, facilitation, mediation, fact-finding, mini-trials, arbitration, and use of ombudsmen."

b. The Court of Appeals for the Federal Circuit has interpreted FAR 33.201 to require a pre-existing dispute before a contractor can submit a valid CDA claim to the contracting officer in certain circumstances. The court ruled that FAR 33.201 requires that a "routine" request for payment (e.g., a voucher or an invoice) must be in dispute before it may be submitted as a CDA claim. "Non-routine" requests need not be in dispute before submission. Non-routine requests for payment are requests for a price adjustment for unforeseen or unintended circumstances that cause an increase in contract performance costs. Events that give rise to requests for price adjustments include: Government modification of the contract (Changes clause); differing site conditions (Differing Site Conditions clause); defective or late-delivered Government property (Changes clause); or issuance of a stop

work order (Suspension of Work clause or Stop Work Order clause). In addition, termination for convenience settlement proposals are also non-routine and may qualify as a CDA claim (see below).

c. CDA claims include:

- requests for price adjustments for work already performed, containing all three CDA elements, that are submitted to the CO for a decision
- price adjustment proposals, containing the three CDA elements, for work that has been performed. However, the contractor did not invoke CDA procedures (mandatory contracting officer's decision) when initially submitting the proposal, but subsequently requests a CO's decision.
- termination settlement proposals where either (1) the CO is implicitly required to issue a final decision because negotiations are at an impasse, (2) the CO unilaterally issued a final decision, or (3) are submitted to the CO for a decision (refer to 12-101i)
- routine requests for payment, such as progress payments or public vouchers, when entitlement or quantum is in dispute that are submitted to the CO for a final decision.

d. The validation of a contractor's claim to CDA requirements is the responsibility of the CO. Therefore before proceeding with the audit, the auditor should consult with the CO on the determination as to whether: (1) a price adjustment is a proposal or a claim, (2) a routine request for payment is a claim, or (3) a termination settlement proposal is a claim. The audit report should indicate that the results of audit are based on the CO's determination as to the conformity of the request to CDA requirements.

e. It is important to know whether a submittal is a proposal or a claim because of the effect on certain audit issues. These audit issues include:

(1) accurate terminology in reporting (refer to 10-1102);
(2) proper type of certification (refer to 12-505 and 12-506);
(3) allowability of claim preparation legal and consulting costs (refer to 12-606); and
(4) allowability of interest (refer to f.).

f. The Contract Disputes Act requires that the Government pay interest on amounts found due on the claim at the rate established by the Secretary of Treasury. Thus, the rates used for computing interest on contract claims are the same as the cost of money rates listed in 8-414.2. Interest on contract claims accumulates from the date the contracting officer receives a valid claim until the payment date. Although not part of the audit of a claim, contracting officers may request assistance in computing the interest on a claim once it has been settled. Accordingly, it is critical to provide timely audits of claims. When the contractor submits an inadequate claim, the auditor should immediately coordinate with the CO using the procedures in 12-503.

12-505 Claim Certification Requirement

a. For contractor demands for immediate payment of money exceeding $100,000, the Contract Disputes Act (CDA) requires the prime contractor to certify that the claim is made in good faith, the supporting data are accurate and complete to the best of its knowledge and belief, the amount requested accurately reflects the contract adjustment for which the contractor believes the Government is liable, and the person signing the

certificate is authorized to bind the contractor. Claims submitted under the CDA must be certified even when placed into alternative disputes resolution (ADR).

b. A contracting officer must issue his or her final decision on a certified claim of over $100,000 within 60 days of receipt or notify the contractor when the decision will be issued. A claim received but not evaluated for adequacy and/or audited in a timely manner could cause a contracting officer to fail to comply with the statutory time limit. Thus, a delay in the audit of a certified claim may force the Government into unnecessary litigation.

12-506 Proposal Certification Requirement

a. Under DoD contracts, the prime contractor must certify requests for equitable adjustment proposals that exceed the simplified acquisition threshold (DFARS 243.204-71). The simplified acquisition threshold is $150,000 except for acquisitions of supplies or services that are to be used to support a contingency operation, or to facilitate defense against, or recovery from, nuclear, biological, chemical, or radiological attack. For contracts subject to the exception, the threshold is $300,000 for any contract to be awarded and performed, or purchase to be made, inside the United States; and $1 million for any contract to be awarded and performed, or purchase to be made, outside the United States (FAR 2.101). The threshold is met by adding together the absolute value of each contract increase and decrease (DFARS 243.204-71(b)). A request may not be paid unless the proposal was certified. Per DFARS 252.243-7002, a prime contractor representative is required to certify at the time of submission that the request is made in good faith and that the supporting data are accurate and complete to the best of his/her knowledge and belief. The certification of a proposal does not substitute for the certification required under the Contract Disputes Act (see 12-505) for a claim.

b. The certification also requires the contractor to make full disclosure of all relevant facts, including certified cost or pricing data if required and actual cost data and data to support any estimates even if certified cost or pricing data is not required.

c. If a proposal lacks a required certification, the auditor should contact the CO to determine if a certification was provided.

12-507 Exit Conferences on Price Adjustment Proposals or Claims

a. Upon completion of the field work of a price adjustment proposal or claim, hold an exit conference per 4-304.1. Prior to holding the exit conference, coordinate with the contracting officer or Government trial attorney. If an audit is performed on a claim that is in litigation and is performed at the request of a Government trial attorney, the attorney may state in writing that the audit working papers and report will be covered by the attorney work product privilege and therefore should not be provided to the contractor without the attorney's written consent (See 4-304.7). In any case, non-DCAA personnel do not have the authority to overrule or to influence the auditor's judgment as to the appropriate content of the audit report. No information should be excluded from the audit report that is a material part of the audit conclusions (see 2-203).

b. Price adjustment proposals and claims may include estimates for work not yet completed and incurred costs or estimates based on incurred costs. Considering any restrictions outlined above, discuss at the exit conference with the contractor any factual differ-

ences found during the audit for estimates of future work included in the proposal or claim. For incurred costs or estimates based on incurred costs included in the proposal, discuss all audit conclusions with the contractor's designated official and try to obtain the contractor's reaction for inclusion in the audit report.

12-508 Auditor Participation in Alternative Dispute Resolution (ADR)

a. DoD has directed the use of ADR techniques as an alternative to litigation or formal administrative proceedings whenever appropriate (DoD Directive 5145.5). ADR refers to an array of dispute resolution methods that involve the use of third-party neutrals to aid the parties in resolving contract controversies using a structured settlement process. Often, auditors are asked to participate in ADR processes to assist in resolving equitable adjustment proposals or Contract Disputes Act (CDA) claims. Ordinarily, the auditor's participation in ADR should not differ from the role of an advisor to the contracting officer when resolving equitable adjustments through administrative proceedings, or the Government trial attorney litigating a CDA claim (1-403.1, 1-406, and 15-500).

b. Auditors may learn more about ADR by studying the Electronic Guide to Federal Procurement ADR, available on the Internet at http://www.adr.af.mil/iadrwg. The Guide was developed and published by the Interagency Alternative Dispute Resolution Working Group, including representatives from DoD and other Federal agencies. In Section III, Administering the ADR Process, Item D, Role of the Auditor, the guide explains the importance of obtaining audit input on financial matters as part of ADR.

12-600 Section 6 --- Price Adjustment Proposals or Claims - General Audit Guidance

12-601 Introduction

This section provides guidance that applies to contractor proposals and claims for price adjustments under the delay/disruption or the standard changes clauses of the FAR.

12-602 Scope of Audit and Special Audit Considerations

a. Depending upon when the request for price adjustment was prepared, contractor proposals may contain forecasted costs, actual costs, or a combination of both. For example, proposals that result from a Government-directed change and are submitted prior to implementation of that change would be based on estimated costs. Price adjustment requests (proposals or claims) that result from alleged abnormal conditions, such as delay/disruption, are usually submitted after the work is complete and therefore should be based on costs incurred. Guidance for auditing forecasted costs is contained in Chapter 9, while guidance for incurred costs is in Chapter 6. Coordination and acknowledgment of the audit request in accordance with 4-104 is critical to ensure the customer's needs will be met.

b. When proposals or claims relate to multiple contract issues, contractors often summarize their proposed or claimed costs by contract issue instead of by cost element. In these cases, auditors should perform additional procedures to ensure costs are not overstated or duplicated. Auditors should compare the total costs claimed for each significant cost element for all issues to the job cost ledger and/or bid/budget for each cost element. The auditor should discuss any significant differences with the contractor to determine the cause of the difference.

12-603 Extended Overhead versus Unabsorbed Overhead

Many courts have used the terms "extended overhead" and "unabsorbed overhead" interchangeably, but careful examination and comparison of their meanings reveal their difference. Unabsorbed overhead occurs if increased costs are allocated to other contracts because of work stoppage occurring on a delayed contract. Guidance for auditing a request to recover unabsorbed overhead is contained in 12-803. Extended overhead applies to contract changes that usually extend the period of performance. Overhead on increased direct costs related to the change is recovered through an indirect rate computed in accordance with the contractor's established accounting practices.

12-604 Prior Contract Briefing

a. Prior contract modifications may contain provisions that waive contractor rights to future price adjustments that arise from the same facts and circumstances. Whether or not a contractor has waived its rights is a legal question; however, the auditor should provide the requestor with any meaningful observations regarding prior contract-modification waivers. Therefore, the auditor should brief prior contract modifications to determine if any such waivers exist.

b. Auditors should also brief prior contract modifications to ensure current claimed/proposed costs have not been previously included under prior contract modifications. Whether or not prior contract modifications relating to the same facts and circumstances contain a contractor's waiver (see 12-604a) the auditor should question any costs in the current claim that are duplicative of costs reimbursed under prior contract modifications.

12-605 Subcontractor Equitable Price Adjustment Proposals or Claims

a. The prime contractor has the responsibility to review the subcontractor's proposal when certified cost or pricing data are obtained and the amount of the prime proposal exceeds the threshold per FAR 15.403-4(a)(1). The prime contractor should include the results of that review in its proposal when the subcontract exceeds the pertinent threshold in FAR 15.403-4(a)(1) or (2). The guidance contained in 9-104 applies to these subcontracts.

b. Subcontractors may not file a claim directly against the Government under the Contract Disputes Act of 1978 under their own name because they do not have privity with the Government. However, they may file a claim against the Government under the sponsorship rule. Under this rule, the subcontractor either (1) has the permission of the prime contractor to file a claim in the prime contractor's name or (2) has the prime contractor file the claim directly. Since the prime is the party to the Government contract with privity, the prime contractor (not the subcontractor) must submit a certification under the CDA of 1978 when the claim exceeds $100,000 (see 12-505). If the subcontractor submits a claim without the proper certification by the prime contractor, the submission is considered inadequate. See 12-503 for further guidance. In submitting the CDA certification, the prime contractor does not vouch for the accuracy of the subcontractor's claim. Instead, the prime is only required to conduct an inquiry into the claim sufficient to know there is a reasonable basis for the subcontractor's claim and that it is not frivolous or a sham. The submission of the CDA certification establishes a legal presumption that the prime contractor has met this requirement. Absent evidence to the contrary, boards and courts will not look beyond the certification.

12-606 Costs of Preparing and Supporting Equitable Adjustment Proposals or Claims

a. Costs incurred in the preparation and support of a request for equitable adjustment (REA) proposal, and in negotiations with the contracting officer are allowable. However, refer to 7-2105 for further guidance on the allowability of professional and consultant costs.

b. Costs incurred in the prosecution of a claim or appeal against the Federal Government are unallowable per FAR 31.205-47(f)(1). The use of the alternative disputes resolution (ADR) process does not make the costs allowable. Costs incurred in the prosecution of a claim include:

- legal, accounting, and consultant fees relating to the preparation and submission of a CDA claim
- costs incurred supporting negotiations subsequent to claim filing
- costs incurred in providing information to the contracting officer in support of claimed costs

- costs incurred in the appeal of the contracting officer's decision to an agency board of contract appeals, the Court of Federal Claims, the Court of Appeals for the Federal Circuit, or ADR procedures.

c. While there is a strong legal presumption that costs incurred prior to the filing of a CDA claim are not unallowable claim prosecution costs, if factual evidence clearly and directly relates the costs to the submission of a CDA claim, the auditor should question those costs. Claim prosecution costs incurred after the submission of the CDA claim to the contracting officer are unallowable even if incurred in support of negotiations. In addition, costs associated with an ADR process (FAR 33.214) on a CDA claim upon which a final contracting officer decision has been issued and appealed are unallowable claim prosecution costs.

12-607 Chronology of Significant Events

Prepare a chronology of significant events to highlight potential key issues (an example is shown in Figure 10-11-1). Such a chronology enhances understanding of significant events leading up to or having a bearing on the proposal or claim. The contracting officer is required to provide a list of significant events when requesting an audit of a request for price adjustment per FAR 43.204(b)(5). If a list is not provided with the request for audit, contact the contracting officer and request that the list be provided. The list of significant events from the contracting officer should include:

a. Date(s) of contract award and/or modifications and dollar amounts;

b. Date of initial contract proposal and dollar amount;

c. Date(s) of each cited alleged delay or disruption;

d. Key performance dates (deliveries or other major milestones) scheduled at date of award and/or modification;

e. Actual performance dates;

f. Date entitlement to a price adjustment was determined or contracting officer decision was rendered, if applicable;

g. Date of certification of request for adjustment if certification is required;

h. Dates of any pertinent Government actions or other key events during contract performance which may have an impact on the contractor’s request for price adjustment.

12-608 Format, Content, and Distribution of Audit Report

a. Use the guidance in 10-1100, and Figure 10-11-1 of Chapter 10 in preparing and issuing audit reports on price adjustment proposals or claims. Sufficient narrative information should be included to provide the reader with a comprehensive understanding of the basis of the contractor's proposal or claim and the audit results. Include the contractor's reaction on all factual differences and the related auditor comments.

b. Despite the need to provide a basis for settlement, qualify the report (or render an adverse opinion) whenever the contractor's supporting documentation is not sufficient to support a conclusion on the acceptability of the submitted costs, and question the costs. Include a description of the documentation required to remove the report qualification.

12-700 Section 7 --- Auditing Submissions Under the Changes Clause

12-701 Introduction

FAR 52.243 provides the basis for price adjustments resulting from contract changes. Entitlement is a legal question; however, the auditor should provide the requestor with any meaningful observations regarding the question of entitlement. These observations may be provided in the audit report explanatory notes or in an appendix on other matters to be reported. Audit conclusions should be based on audit evidence related to quantum issues (refer to 12-802.1).

12-702 Special Audit Considerations

a. Auditors should evaluate the effort required by the contract and related modifications to determine if costs included in the submission are not already provided for under existing contract provisions. The auditor should also similarly evaluate proposals submitted for the contract which have not yet been negotiated.

b. For construction-type contractors, there are unique types of records that need to be considered, such as job site diaries, equipment utilization and maintenance records, and project status reports. These records include important information that should help substantiate the submitted costs.

12-703 Profit on Equitable Adjustment Claims

a. FAR 52.243, Contract Modifications, provisions and clauses, does not specifically exclude profit from requests for equitable adjustment under the provisions of the changes clauses (see 12-802.7 for delay/disruption clauses that exclude profit).

b. Contracting officers are responsible for determining profit rates and amounts for equitable adjustment proposals or claims. In those cases where submitted costs are questioned, do not question profit. However, to assist the contracting officer, compute the potential questioned profit using the proposed or claimed rate and show it in an explanatory note along with advisory comments such as evidence of underbidding. Identifying the rates as “proposed” or “claimed” will avoid any misunderstanding that the auditor is recommending a specific profit rate.

12-704 Equitable Adjustment Proposals or Claims - - Total Cost Method

12-704.1 Introduction

a. This section provides guidance for the audit of increased costs allegedly caused by Government action or inaction in proposals or claims which were computed using the total cost method.

b. The total cost method is sometimes used by contractors as a basis for calculating damages for an equitable adjustment. Under this method, the estimated cost of the work (the negotiated price net of profit or the contractor’s bid plus any modifications) is subtracted from the total cost of the work performed to determine the claimed amount. For example, a contractor had a firm-fixed-price contract for $1,980,000 to construct a

building. Three months into the contract performance, the Government issued one change order to the contract that significantly changed the design of the building. The contractor's total costs incurred on this contract at completion were $2,800,000. The contractor was able to show from bid cost sheets that the original cost estimate was $1,800,000 with a $180,000 profit. The contractor, therefore, claims that as a result of the Government's change, it is entitled to an equitable adjustment of $1,100,000 ($2,800,000 - $1,800,000 costs bid = $1,000,000 + $100,000 profit). The total cost method presents a considerable risk that the Government will pay for costs that are not related to the change. The courts (WRB Corporation v. United States, 183 Ct. Cl. 409 (1968) and Servidone v. United States, 931 F.2d 860 (Fed. Cir. 1991)) have identified four criteria of proof that the contractor must meet for the method to be accepted as a basis for pricing a claim. The boards of contract appeals and the courts have mostly rejected the method when the contractor is unable to meet the criteria. The criteria are:

- the nature of the change(s) makes it impossible or impracticable to directly determine actual related increased costs with a reasonable degree of accuracy;
- the contractor's bid was realistic;
- the actual incurred costs were reasonable; and
- the Government was responsible for all the differences between the bid and incurred costs.

c. Total cost method calculations are often modified to eliminate some of the inherent inaccuracies found in this method. This is then referred to as the modified total cost method. See 12-704.5 for guidance on the modified total cost method.

d. The contractor's computation of damages using the total cost method should be of last resort and should be used only in extraordinary circumstances when no other way to compute damages is feasible. Discrete proposal or claim pricing (that is, detailed pricing of specific additions and deletions) is the preferred method. The courts expect the contractor to make a reasonable attempt to use other methods. The fact that a contractor incurred more costs in excess of the bid or contract price does not necessarily indicate that there were changes, delays, acceleration, changed conditions, or disruption caused by the Government. A contractor who underestimates its bid or incurs unanticipated costs or costs due to inefficiencies may not use an equitable adjustment proposal or claim as a means to shift the risks or losses to the Government (see 12-705).

e. Proposals or claims are often based on several methods of pricing to include elements based on the total cost method, modified total cost method, estimates, estimates based on actuals, actual (segregated) discrete costs, and projected costs for future work. When a contractor computes damages using both total cost method and discrete costs, this may indicate that its accounting system was capable of segregating costs incurred specially on alleged change(s) but the contractor chose not to utilize the system's capabilities. Such information should be disclosed in the audit report.

12-704.2 Audit Objectives

Determine if proposed or claimed costs are acceptable as a basis for negotiation or settlement. In particular, the audit should determine whether the contractor has met the four criteria for applying the total cost method or modified cost method. Failure to meet the four criteria indicates that the contractor's proposal or claim for increased costs is not adequately supported and therefore should not be the basis for determining damages.

Unsupported costs should be questioned. All findings related to the contractor's ability or inability to meet the criteria for using the total cost method should be provided in the audit report.

12-704.3 Audit Considerations

a. In some instances, contractors have applied the total cost method or modified total cost method to only certain elements of the proposal or claim. Contractors do not always indicate that a cost element is priced using the total cost method or the modified total cost method. In the audit report, auditors should indicate those elements where the contractor applied the total cost or modified total cost method. For example, in a claim for lost productivity, a contractor compared actual labor hours incurred on a contract to those estimated in its bid and labeled the computation a "productivity analysis." Nevertheless, the methodology was the total cost method. Therefore, auditors should evaluate all proposals or claims to determine those elements that are priced using the total cost method or modified total cost method and apply the guidance in this section to those elements.

b. Brief the contract for clauses unique to the service component or agency that may limit costs. Auditors should analyze each change requested for limitations. For production contracts, determine if the contract contains First Article Testing provisions (FAR 52-209-4(c)), that may limit the costs for retests. Prior modifications to the contract should be reviewed for duplication of costs in the claim. Also the contractor may have submitted Engineering Change Proposals for relaxation of technical requirements that were included in the proposal or claim.

c. Technical assistance is critical in a total cost method audit. The determinations of the reasonableness of bid and incurred labor hours or material types and quantities are some of the technical aspects of the claim. Include in the request sufficient details of the issues that the technical specialist should address to ensure that when the technical report is written, the findings can be readily incorporated into the DCAA audit. A meeting with the technical specialist will help to ensure that there is a mutual understanding of the audit requirements.

12-704.4 Analysis of Criteria

The auditor should consider the following issues, if relevant to the circumstances, to determine if the contractor meets the criteria to use the total or modified total cost method for pricing its proposal or claim.

a. Impossible to determine actual related increased costs.

When the contractor has the opportunity and ability to segregate claimed costs but fails to do so, the Government should place less reliance on the claimed amounts. The contractor is expected to take reasonable steps to determine the actual costs with a reasonable degree of accuracy if:

- the contractor is, or should have been aware of changed work and/or informs the Government as it starts;
- the contractor's accounting system is capable of recording increased costs related to the changed work;
- the nature of the changed work lends itself to segregation and separate accumulation; and

- the contractor has demonstrated the ability to segregate and accumulate specific costs incurred under a contract.

Under the circumstances listed above there would appear to be no justification for not making a reasonable attempt to segregate the costs. Audit procedures include:

(1) Evaluating the contractor's accounting system to determine the capability and requirements to separately account for increased costs caused by the asserted changes. Determine if the contractor's policy and procedures require separate accounting for changed work. Review prior audit reports related to the period of contract performance on the adequacy of the contractor's accounting system. Determine if there were any accounting system deficiencies that would have impacted the contractor's ability to segregate the costs of the changed work.

(2) Determining if the contract included the Change Order Accounting clause. FAR 52.243-6 requires the contractor to have the capability to segregate the costs of changes if so directed by the contracting officer. Determine if the CO issued any directives requiring the contractor to establish separate cost accounts for activities related to changed work and if the contractor complied with the directive.

(3) Reviewing the disclosure statement for statements regarding the capability of the accounting system to segregate costs when necessary, if the contractor is CAS covered. For major manufacturing concerns, the accounting system should have the capability to collect and process cost data within a work breakdown structure and to expand work packages to a detail level. Determine if the contractor followed its disclosed practices and if not, why.

b. Bid was realistic.

A contractor who underestimates its bid may not use an equitable adjustment proposal or claim as a means to shift the risks or losses to the Government. Perform the following analytical procedures:

(1) Compare the bid with Request for Proposal (RFP) requirements. Normally the bid price is the contract price and is ascertainable from the contract, CO or the contractor. For example, a contractor bid a shorter delivery schedule than required by the RFP. A delivery schedule that is significantly shorter than that of the RFP may indicate an unrealistic bid. Also review the bid to ensure that the contractor bid all normal overhead rates or essential tasks or labor categories. If the contractor failed to bid significant elements of cost, it is likely that the bid is unrealistic. For example, the Government changed the contract specifications and drawings three weeks after the contract was signed. After contract completion, the contractor showed the auditor various contract cost records. These records showed that a private technical consultant had provided substantial aid to the contractor in assisting with the changed specifications. The accumulated cost of the consultant's services was $100,000 which the contractor claimed in an equitable adjustment. The contractor pointed out that the bid did not include any costs for this consultant and his work was caused by the Government's changing of the specifications. However, when reviewing the CO's contract documentation, the auditor found that the consultant had attended a post-award conference four days after the contract was signed (and prior to any notification to the contractor of changed specifications). The documents recorded that the consultant was expected to spend 300 hours working on the contract as originally planned at $125 per hour. Thus, $37,500 would have been spent on the consultant even without the change in specifications. Therefore, only $62,500 ($100,000 - $37,500) would be accepted as part of the equitable adjustment.

(2) Compare the contractor's bid with other contractors' bids for the same acquisition, if available from the contracting officer. Compare the proposed price to recent historical data of similar work. If the bid is significantly less, there is a risk that the contractor underbid and therefore the estimate was not realistic. Compare the contractor's bid delivery schedule with those of unsuccessful bidders. Technical assistance may be needed to determine the realism of the bid delivery schedule.

(3) Compare bid cost elements to incurred cost elements. Those elements where the bid and incurred costs are reasonably close would indicate a realistic bid. Those elements where the bid and the incurred costs are significantly different should be examined to determine the cause of the difference.

(4) Review prior audit reports on the contractor's estimating system for deficiencies that may have impacted the reasonableness of the bid. For example, does the contractor fail to consider similar experience on other contracts when bidding labor hours? Such a deficiency may indicate that the bid labor hours were excessively high because prior experience was not considered. Technical assistance may be required to determine if the bid hours were overstated.

c. Incurred costs were reasonable.

The contractor is expected to base the claim on incurred costs related to the changed work. Two acceptable pricing techniques used in determining the actual costs to the contract are:

- estimates made prior to the performance of the effort subject to equitable adjustment, and
- retroactive techniques using actual cost data.

Evaluation techniques include:

(1) Reconciling the claimed costs to the contractor's books and records. Question those costs proposed or claimed that were not incurred or would not be incurred. Determine if the incurred costs were allocable, allowable and reasonable in nature.

(2) Obtaining technical assistance to determine the cost realism of the estimate to complete if the contract is not yet complete and the proposal or claim includes an estimate to complete.

(3) Determining if the contractor used estimates based on incurred costs. Because of the failure to segregate actual costs related to the changed work, contractors may not use actual cost data. For instance, a contractor may estimate labor hours although actual hours are available. Any add-on factors increase the risk to the Government of paying for costs not related to the alleged extra contract work. Estimates have no presumption of reasonableness.

(4) Evaluating changed methodology, such as changed labor mix or revised make-or-buy decisions. If the contractor substituted one type of labor for another after the contract was awarded, there is a possibility that some increased costs are attributable to the substitution rather than to a claimable activity. If after bidding, the contractor decides to make rather than buy a part, some of the cost growth in a labor account could be due to a post-bid decision to make the part rather than buy it. Also, the contractor could decide to buy a part rather than make it after bidding. Therefore, the cause of cost growth in the material account could be attributable to that decision.

d. Government is clearly responsible for the increased costs.

There should be a cause and effect to show the Government's responsibility for the increased costs.

(1) Review the contract budgets for the period of performance and the contractor's policies and procedures for comparing actual performance to the budget. Identify and analyze variances the contractor should have identified as work was accomplished. Gather information on contractor-caused increased costs and increased costs due to the alleged changed work. For example, a contractor had the task of manufacturing six engines under a fixed price contract. The bid cost of each engine was $100,000. After the contractor had manufactured the first engine, the Government decided that the design should be changed. The newly designed engine cost $225,000 to manufacture. The contractor asked for an equitable adjustment of $125,000 per engine. The auditor, however, discovered that the first engine manufactured by the contractor, using the original design, actually had cost $150,000 and if the contractor had made all six engines using its own design, it would have experienced a $50,000 overrun on each engine. For this reason, the equitable adjustment per engine would only be $75,000 per engine ($225,000 - $150,000) rather than the $125,000 per engine claimed by the contractor.

(2) Determine if the contractor implemented any accounting changes having impacts that were not considered in the claim.

(3) Determine if the contractor recognized any increased costs attributable to its own mismanagement in scheduling or materials procurement. Also review correspondence between the contractor and subcontractors for indications of subcontractor failures to perform according to schedule, or other issues that would cause increased subcontract costs.

(4) Determine if there were extraordinary equipment repairs or delayed material ordering or deliveries that were charged to the contract and not the responsibility of the Government. Higher than normal material scrap costs may indicate contractor-caused cost growth. Bad weather during the performance period may have caused delays in performance or damages to construction sites that were not Government-caused.

(5) Evaluate increased incurred overhead costs that may have been caused by loss of planned contract awards, contractor-caused delays, or contract terminations that are not the responsibility of the Government under this contract. For example, the contract price used the contractor's indirect bid rate of 115% applied to labor, or $11,500 per unit for a 200 unit contract, a total of $2,300,000. After a Government-caused delay, the actual indirect rate was 130% of labor, or $2,600,000. The contractor submitted a claim for the $300,000 difference. However, during the audit of the claim, the auditor found that at the time of award, two of the contractor's major contracts had ended and were not replaced. Had the contractor taken this into consideration in the bid, the indirect bid rate would have been 125% of labor, or $2,500,000 for 200 units. Therefore, the auditor questioned $200,000 of the claim and requested a technical review of the remaining $100,000.

(6) Determine if the prime contractor proposed or claimed hours that were actually performed by a subcontractor. If the subcontract was firm-fixed-price and there was no change to a cost reimbursable subcontract, any claimed hours would not be related to a liability of the prime contractor. Therefore the contractor would be requesting the Government to pay for costs not incurred.

12-704.5 Modified Total Cost Method

The modified total cost method is the most frequently used costing approach for equitable adjustments. The method starts with the total cost method calculations, as described in 12-704.1b, total costs incurred on the contract less the total bid or estimated costs. The

results of this computation are then adjusted for admitted underbidding or contractor inefficiencies. The contractor may adjust the original bid costs to remove inaccurate bid costs or add in costs explicitly excluded from the original bid. Also, costs that are the responsibility of the contractor (contractor-caused delays) or are not the responsibility of the Government are removed from the actual costs. For example, a contractor's total cost on a firm-fixed-price contract was $1 million. The bid costs were $600,000. There was a change order three months after the award of the contract. The contractor's "cost growth" was $400,000 ($1,000,000 - $600,000 = $400,000). The contractor identified $100,000 of costs incurred because of its own inefficiencies. The contractor attributed the remainder of the cost growth, $300,000 ($400,000 - $100,000 = $300,000), to the Government change. However, there is a risk that the contractor did not eliminate all costs that are not the responsibility of the Government. Most of the objections to the total cost method remain. However, the courts have granted recovery under the modified total cost method (Servidone Construction Corporation v. United States, 931 F.3d 860 (Fed. Cir. 1991). The same criteria that are applied to the total cost method should be applied to the modified total cost method. Refer to 12-704.1-5 for further guidance.

12-705 Unrelated Costs

Except as permitted under 50 U.S.C. 1431-1435 (see 12-900), an equitable adjustment should not be used to increase or decrease a contractor's profit or loss position for reasons unrelated to the change (Pacific Architects and Engineers Inc. and Advanced Maintenance Corp. v. U.S., 491 F.2d 734, 203 Ct. Cl. 499 (1974)). Therefore, a contractor that underestimates its bid (refer to FAR 3.501-1) or incurs unanticipated costs or inefficiencies may not use the occasion of a price adjustment for new or modified (changed) work as a means to shift those already-priced risks or losses to the Government. The auditor should ensure that the contractor is not proposing or claiming costs unrelated to the changed work. Such unrelated costs may include labor rates, labor hours, indirect costs, direct material, and other direct costs. For example, a contractor may have experienced an unanticipated increase in labor costs prior to performing the change effort. Any attempt to reprice the labor on the entire or unchanged work should be questioned because it represents the contractor's assumed risk at contract formation. However, the contractor undertakes a new and unpriced risk when performing additional or changed work which was not anticipated at the time of award and which it is obligated to perform under the Changes Clause (Appeal of Stewart and Stevenson Services, Inc., ASBCA No. 43631, 97-2 BCA 29,252). Therefore, the change order effort can properly include the cost of performance including the increased labor costs for the changed effort. Technical assistance may be required to evaluate labor hours or material quantity costs. Question those costs included in the proposal or claim that represent increased costs unrelated to the change.

12-800 Section 8 --- Auditing Delay/Disruption Proposals or Claims

12-801 Introduction

a. A proposal or claim for delay/disruption is an assertion by a contractor that its costs were increased because of a Government-caused delay/disruption of its contract performance. The delay/disruption may extend contract performance within the same accounting period or to a subsequent accounting period(s).

b. Delay/disruption can cause the contractor to slow down or stop work, or perform work in an uneconomical manner. For example, some reasons for Government-caused delay/disruption include late delivery of or defects in Government-furnished material, equipment, or plans, or unusual conditions not known or anticipated when establishing the contract price. Also, changes in a Government contract resulting from defects in Government-furnished specifications or drawings can result in delays.

c. Use the standard audit programs, under activity code 17200, for performing price adjustment delay/disruption proposal or claim audits. These programs are included on the DCAA Intranet and the APPS.

12-802 Special Audit Considerations

Because of the unique nature of delay/disruption proposals or claims, it is important to closely coordinate in writing with Government technical personnel, using 4-104 and Appendix D for guidance. Request technical assistance as needed to understand the nature of the alleged abnormal condition (e.g., the causes, particularly the Government's participation, the duration, and the impact on work performance).

12-802.1 Entitlement and Quantum

a. Entitlement. Entitlement relates to whether the contractor has been impaired by Government action and therefore has a right to a monetary adjustment. Entitlement is a legal question; however, the auditor should provide the requestor with any meaningful observations regarding the question of the contractor's entitlement to recover delay damages (refer to 12-804c). These observations may be provided in the audit report explanatory notes or in an appendix on other matters to be reported.

b. Quantum. The purpose of the audit of a delay/disruption proposal or claim is to evaluate the quantum to determine if the proposed or claimed costs are acceptable as a basis for negotiation or settlement. Quantum is the amount of the monetary adjustment, assuming that the contractor’s assertion of entitlement is proven valid. The audit effort should be directed toward examining the contractor’s proposed or claimed costs (quantum) to determine if they are acceptable if the contractor were entitled to recover. For example, the auditor should, at a minimum, evaluate:

- If the amount proposed or claimed was incurred or estimated;
- If the contractor has source documents that establish that it incurred the costs at issue;
- If the costs submitted have been correctly allocated or charged to the contract or claim and
- If the costs submitted are allowable, pursuant to FAR 31.205 and the provisions of the contract.

12-802.2 Bonding Costs

a. The Miller Act requires performance and payment bonds for any construction contract exceeding $100,000 (FAR 28.102-1(a)) or when necessary to protect the Government's interest. Costs of bonding required pursuant to the terms of the contract are allowable.

b. Bond premiums are based on the total value of the contract including modifications. Bonding costs may be computed based on the payment rate applicable to the increased cost resulting from the delay. For example, a bonding formula may require payment at a rate of $10 per thousand for the first $500,000 of total contract costs, and a payment of $7 per thousand when total contract costs exceed $500,000. In such a case, if the original contract award is $525,000, the proper payment rate for the delay costs would be $7 per thousand, since the contractor has already exceeded the threshold for applying the $10 per thousand payment rate.

12-802.3 Labor

Some examples of reasons for adjustments to labor costs resulting from delay/disruption include (1) changes in labor rates because scheduled work was performed in another period or by different personnel than proposed, (2) changes in the number of hours required for maintenance or standby labor and/or changes in efficiency or learning, and (3) changes in required hours because of slow down or stoppage of work or work performed in an uneconomical manner. Changes in rates can normally be verified to the contractor's payroll records. The auditor should consider the use of improvement curve analysis to evaluate proposed adjustments in labor costs. Technical assistance may be particularly helpful in this area.

12-802.4 Indirect Costs – General

a. General. Indirect costs allocable to direct costs incurred as a result of the delay are allowable when computed in accordance with the contractor's established accounting practices (see 6-600). Any indirect cost (including unabsorbed overhead) that was submitted as direct cost must be excluded from the computation of rates allocable to the delay/suspension proposal or claim. In addition, for purposes of determining overhead rates for flexibly priced contracts, the applicable indirect cost pool should be reduced by the amount of indirect costs charged as direct costs under this delay/disruption proposal or claim. Failure to make these adjustments will result in a duplicate recovery of costs.

b. Construction Job Site/Field Overhead. Job site/field overhead consists of expenses required to support a construction contract that are not identifiable with any specific work or task within the contract. Job site/field overhead includes salaries for project managers, superintendents, guards, mechanics, and engineers; rental or ownership costs for offices, storage trailers, office equipment and supplies; temporary utilities (electricity and water); trucks; and automobiles. Contractors propose or claim recovery of job site/field overhead on change orders that increase work and/or extend the performance period of a contract. When the Pricing of Contract Modifications clause (DFARS 252.243-7001) is contained in the contract, evaluate the costs per FAR 31 cost principles. Evaluate the proposed or claimed job site/field overhead costs to ensure that costs associated with the overall opera-

tion of the business (home office overhead) are not included. Job site/field overhead costs are allowable as direct or indirect costs provided the costs are charged in accordance with the contractor's established accounting system and consistently applied for all contracts (FAR 31.105(d)(3)). In M. A. Mortenson Co., ASBCA Nos. 40750, 40751, 40752, 98-1 BCA ¶29,658, the Senior Deciding Group of the board ruled that FAR 31.203, when applicable, prohibits a contractor from using more than one allocation method for recovery of job site/field overhead. In this case, the contractor used a per diem method (daily field overhead rate) when claiming job site overhead for changes and delays that increased the contract performance period but used a percentage markup method for changes that did not affect contract performance period. The latter approach was rejected since it was a departure from the contractor's normal per diem method and violated the FAR requirement for a single distribution base for allocating a given overhead pool. In Caddell Construction Co, ASBCA No. 49333, 99-1 BCA, the board found irrelevant a contractor's assertion that by deducting field overhead received as a percentage markup from the field overhead pool used to calculate the per diem rate, recovery of excess field overhead would be avoided. Despite this assurance, the contractor would have been in violation of FAR 31.203(b) as interpreted in Mortenson.

12-802.5 Equipment Costs On Construction Contract Proposals or Claims

a. Contractors may claim increased costs because the equipment used in the performance of the contract sat idle during the asserted period of delay. Increased equipment costs on construction claims are allowable, but are subject to specific FAR provisions regarding their measurement. FAR 31.105(d)(2)(i)(A) states that actual equipment cost data should be used when it is available, both for equipment ownership costs (generally including depreciation and cost of facilities capital) and equipment operating costs (including such items as repair costs, fuel costs, and equipment rental costs). FAR 31.105(d)(2)(i)(B) gives additional examples of equipment operating costs. This FAR section states that in order to use actual cost data, it must be available for each piece of equipment, or for groups of similar series or serial equipment. However, when equipment is idle, it is not appropriate to charge rates or actual costs reflecting operating costs, such as gas, fuel, and operators, that are incurred only when the equipment is operating.

b. If actual cost data is not available, FAR 31.105(d)(2)(i)(A) permits the contracting agency to specify the use of predetermined rate schedules to compute equipment costs. Such schedules are developed by various Government and industry organizations and utilize various methodologies to develop cost rates for construction equipment. In the event actual cost data is not available, the auditor should examine the contract to see if a specific rate schedule is mandated. If the contract does not mandate a specific schedule, the choice of an appropriate rate schedule is subject to technical considerations.

c. The U.S. Army Corps of Engineers publishes an Equipment Ownership and Operating Expense Schedule (listed as an example of predetermined rate schedules in FAR 31.105(d)(2)(i)(B). This schedule lists different rates for average and standby usage. The Army Corps of Engineers Schedule also computes rates for average and severe conditions. Analysis of such designations is a technical area. The Corps of Engineers schedule also provides a worksheet to compute hourly equipment cost of equipment not specifically identified, taking into account a number of factors related to cost and usage. The basic methodology by which this or other schedules develop cost rates is also a technical area.

d. FAR 31.105(d)(2)(i)(C) states that when a schedule of predetermined use rates for construction equipment is used to determine direct costs, all costs of equipment that are included in the cost allowances provided by the schedule shall be identified and eliminated from the contractor's other direct and indirect costs charged to the contract. The auditor should examine contract direct and indirect costs charged to ensure that such costs have been removed. If the contractor's submitted equipment costs include costs contained in non-equipment cost categories at the time of bid, or in the contractor's overall accounting records, the auditor should gain an understanding of the reasons for reclassification of these items as equipment costs.

e. The contractor's submitted equipment costs should also be evaluated to ensure that the capitalization policy used to develop equipment rates is in accordance with the contractor's normal capitalization policy for the project. Items not customarily capitalized as equipment should not be submitted in the contractor's equipment costs. For example, if the contractor normally expenses the cost of wheelbarrows or small tools, they should be omitted from equipment calculations.

f. While rate schedules can produce equitable results, they may also produce results significantly different from the actual costs incurred. If contractors use such rate schedules, the auditor should ensure that the FAR criteria permitting the use of the schedules are met, and that the contractor's accounting system is not capable of identifying the equipment contract costs based on the applicable FAR criteria. If such data can be obtained (see a.), however, the schedules should not be used. Even if FAR does not permit a contractor to use actual cost data, however, auditors should comment on any instances coming to their attention where the rate schedules appear to produce inequitable results.

g. The auditor should evaluate the contractor's submitted equipment costs to ensure that the equipment items contained in them can be traced to the contractor's books and records. The auditor should also analyze the accounting assumptions used in the computation of equipment cost. For example, data concerning equipment life, and year entered into service should be reconciled with other job records and companywide financial accounting data. To the extent that assumptions about salvage value are used in the contractor's submitted equipment cost calculations, they should also be verified. Any evidence found that demonstrates that the claimed equipment was used for other work should be reported to the contracting office. When a contractor has several jobs in the same geographical locality, audit risk may exist in this area.

12-802.6 Costs of Preparing and Supporting Proposals or Claims

Costs incurred to prepare a claim against the Government are unallowable (see FAR 31.205-47(f)). However, the costs incurred to prepare a request for price adjustment proposal (see 12-502) are allowable. Refer to 12-606 for further guidance.

12-802.7 Profit

Profit is specifically excluded under the provisions of FAR 52.242-14 and -17. Profit is not specifically excluded for requests submitted under FAR 52.242-15, FAR 52.243, or FAR 52.236-2. Delay/disruption proposals and claims may be submitted under various contract clauses with differing provisions for profit. Therefore, the auditor should evaluate the contractor's support for the proposed profit, including identification of the

contract clause under which the contractor's delay/disruption proposal or claim is being made. See 12-703 for further guidance.

12-803 Auditing Unabsorbed Overhead

a. Unabsorbed Overhead. Unabsorbed overhead damages are often asserted in a delay/suspension price adjustment proposal or claim. They represent fixed overhead costs whose allocation to the contract has been impacted by the reduction in the stream of direct costs caused by the delay/suspension. Unabsorbed overhead is recoverable only if the delay or suspension of work caused the contractor to stand ready to perform to the exclusion of other potential work for an indefinite period (on "standby") (Safeco Credit and Fraley Associates Inc. v. U.S., 44 Fed. Cl. 406 (July 1999).)

The term "unabsorbed overhead" is actually a misnomer because all overhead costs are allocated to, and absorbed by, contracts in process. The term refers to the reallocation of fixed overhead costs among contracts because of the delay/suspension. The delay/suspension results in a contract being allocated less fixed overhead costs than it would have been allocated absent the interruption (the contract underabsorbs). At the same time, other contract(s) are allocated a greater amount of fixed overhead costs than they would have been allocated absent the interruption (these contracts overabsorb). When unabsorbed overhead costs are allocated to other contracts, the cost of performing the remaining work on these contracts (work that was not delayed/suspended) increases. Without compensating upward contract price adjustments, the company's profitability is decreased.

b. Adjustment to Flexibly Priced Contracts. Unabsorbed overhead costs recovered under a delay/suspension submission should be removed from the pool used to determine overhead rates for flexibly priced contracts. If unabsorbed overhead is significant, the auditor should not render closeout reports on contracts for periods in which an equitable adjustment submission is pending. After the submission is settled, the amounts collected for unabsorbed overhead should be subtracted from the expense pool(s) to preclude duplicate recovery.

12-804 Eichleay Method to Measure Unabsorbed Overhead

a. Eichleay Formula the Proper Method. The question of the proper method to measure unabsorbed overhead has been addressed in numerous board and court cases. The Court of Appeals for the Federal Circuit has specifically ruled that the Eichleay formula is the exclusive means for calculating unabsorbed overhead in cases arising out of construction contracts (Wickham Contracting Co., Inc. v. Fischer, 12 F.3d 1574, (Fed. Cir. 1994). The ASBCA has supported the application of the Eichleay formula for the recovery of unabsorbed overhead on manufacturing/supply contracts (Libby Corporation, ASBCA Nos. 40765 and 42553, 96-1 BCA 28,255, affirmed without opinion CAFC 96-1351 (Fed. Cir. 1997)).

b. Entitlement to Unabsorbed Overhead Damages. The U.S. Court of Appeals of the Federal Circuit (CAFC) (West v. All State Boiler, 146 F.3d 1368 (Fed. Cir. 1998) "All State") ruled that the elements of the claim (legal tests) that a contractor must show to recover unabsorbed overhead include:

(1)The delay/suspension was Government caused [when a Government caused disruption results in a delay of contract performance, Eichleay damages may be appropriate].

(2) The Government required the contractor to standby during the delay/suspension period.

(3) It was impractical for the contractor to take on other work.

(4) The delay/suspension caused the contractor to be unable to complete the contract within the original contract performance period, as extended by any modifications.

c. Prima Facie Case. Once the contractor has met these prerequisites, it has established a prime facie case for recovery of Eichleay damages. However, the Government can rebut the contractor's prime facie case by showing that:

(1) It was not impractical for the contractor to obtain a replacement contract(s) during the delay/suspension period;

(2) The contractor's inability to take on other work was not caused by the Government delay/suspension; or;

(3) The contractor was able to reduce fixed overhead expenses during the period of delay/suspension.

All State involved a construction contract. Its rulings on standby and replacement contract(s) have yet to be shown to apply in a manufacturing/supply contract environment. This guidance provides for circumstances involving a manufacturing/supply contract and the application of the Eichleay formula.

d. Report Observations on Entitlement. Report any meaningful observations regarding the question of the contractor's entitlement to recover unabsorbed overhead damages to assist Government officials in determining entitlement issues. Facts or circumstances that could assist the contracting officer in determining entitlement, may include:

- Evidence that the asserted Government delay/suspension did not cause any extension in the actual time of performance beyond the original or previously revised contract performance date.
- Evidence that the contractor was or was not able to begin work on the next new contract in the extension period because of continuing work on the delayed/suspended contract.
- Evidence that the contractor did or did not secure a replacement contract(s) or other substituted work between the start of the delay/suspension period and the end of the period of extension beyond the original or previously revised contract performance date.
- Evidence of contractor-caused delays that were concurrent with the alleged Government delay or suspension.
- Evidence that the contractor was aware of differing site conditions or other causes of the asserted Government-caused delay prior to the original bid submission.
- Evidence that the contractor was unable to obtain replacement work because its bonding capacity was limited due to circumstances unrelated to the Government-caused delay/suspension.

Provide observations on any evidence as discussed above in the audit report explanatory notes or in an appendix on other matters to be reported. See 12-802.1

12-804.1 Eichleay Steps

The three step Eichleay formula and a detailed explanation of each step follows:

Step 1. Fixed overhead allocable to the contract =

Contract billings		Total (fixed)*
Total billings for contract period	x	overhead for contract period

Step 2. Daily contract (fixed)* overhead rate =

(Fixed)* overhead allocable to contract
Days of performance

Step 3. Unabsorbed overhead =

Daily contract (fixed)* overhead rate		Number of delay days
	x	

* The term "fixed" has been added for clarity, although the courts do not include the term "fixed" when stating the Eichleay formula (see 12-804.3).

a. Step 1. The first step computes the total fixed overhead allocable to the delayed contract. Divide the total contract billings (see 12-804.2) for the delayed contract's actual performance period by the total company billings for all contracts performed during the delayed contract performance period (this is referred to as the allocation ratio), and multiply this result by the company's total fixed overhead (see 12-804.3) for the delayed contract's actual performance period. The actual contract performance period represents the actual days of performance (including the extension period) . It is the period from the start date of the contract until the date of contract completion. Note that the contract billings, total billings, the total fixed overhead and the performance days should be for the same time interval, i.e., the delayed contract's actual total performance period.

Price adjustment proposals or claims are sometimes submitted before the completion of the contract. The basic Eichleay formula does not preclude prospective billings from the computations, if they and other formula components including extension beyond original completion date can be reasonably estimated. In such cases, the associated formula components: contract billings, total billings for the contract period, total fixed overhead for contract period, and days of performance should also be extended to cover the entire time interval from the date of award to the date of expected substantial completion.

If the contractor includes additional unsubmitted or unsettled proposals or claims on the subject contract in the computations of contract billings and total billings for the contract period, question these amounts unless entitlement and agreement as to the appropriate amounts have been determined. Amounts for estimated unabsorbed overhead that are included in the claim should be removed from the contract billings component of the Eichleay formula, Step 1, because they represent duplicate recovery. The unabsorbed overhead amount would be included in the same formula used to compute the very same unabsorbed overhead amount.

Advise the contracting officer that unabsorbed overhead should, if possible, be computed and negotiated after all other items of the claim on the subject contract have been settled. This will ensure an equitable settlement is based on established costs.

b. Step 2. The second step computes the daily contract fixed overhead rate. Divide the fixed overhead allocable to the contract by the actual contract performance days. The actual performance days include the original or revised completion date and the extension period.

c. Step 3. Compute the total amount of unabsorbed overhead for the delayed/suspended contract by multiplying the daily contract overhead rate, which is determined in Step 2, by the number of delay days (the number of days of extended performance associated with the Government-caused delay/suspension beyond the original or previously revised completion date). Refer to 12-804.4 for further guidance.

12-804.2 Billings Data

Contract billings, as expressed in the Eichleay formula, are contract revenues recognized for the period of actual contract performance. Total billings are revenues for all contracts (including Government and commercial) recognized for the period of actual contract performance including the delay/suspension and extended performance periods and any previous modifications to the completion date. Contract progress billings do not always represent the recognition of contract revenue and therefore would not be a consistent measure in the formula. Long term contracts often contain complex formulas for progress measurement and payment, which may vary greatly among contracts. Contract revenues include contract costs plus profit.

a. Methods for recognizing long-term contract revenues. There are two generally accepted methods for recognizing long-term contract revenues: completed-contract method and the percentage-of-completion method, including units-of-delivery method. The AICPA Audit and Accounting Guide, Audits of Federal Government Contractors, provides the following description of the two revenue recognition methods:

- Completed-contract method. This method of accounting defers recognition of revenues while a contract is in process. On completion or substantial completion of a contract, aggregate revenues and costs associated with the contract are recognized.
- Percentage-of-completion method. An accounting method that recognizes contract revenues and income on work as a contract progresses. It provides for recognition on a periodic basis rather than on a completed-contract basis.
- Billing data should be available in the contractor's financial statements and schedules summarizing contract cost and revenue data from the contractor's books and records. The completed-contract and the percentage-of-completion methods are mutually exclusive.

b. Consistent revenue recognition methodology. The revenue recognition methodology should be consistent by contract type for contract billings and total billings. The AICPA states in Audits of Federal Government Contractors:

> An entity using the percentage-of-completion method as its basic accounting policy should use the completed-contract method for a single contract or a group of contracts for which reasonably dependable estimates cannot be made or for which inherent hazards make estimates doubtful. Such a departure from the basic policy should be disclosed.

12-804.3 Overhead

The Eichleay formula properly includes only fixed overhead costs (home office overhead for construction contracts) (see Step 1, 12-804.1) in the unabsorbed overhead calculations (Satellite Electric Company v. John H. Dalton, 105 F.3d 1418 (Fed Cir. 1997)). In a manufacturing/supply contract environment, for regular or normal levels of production, certain costs are fixed. These costs include costs for plant capacity or other long-term assets or obligations. These fixed costs also include operating costs that do not vary with business volume, at least within a broad range of activity. Examples of fixed costs include depreciation (unless a units-of-production method is used); property taxes; support staff salaries such as secretaries, accountants, and executives of the company; other home office expenses; insurance; and basic maintenance. For normal fluctuations in a business, fixed cost levels remain relatively constant year after year (see 9-703.2b). On construction contracts, home office overhead costs should include only fixed costs that benefit all contracts and are thus prorated to all contracts. Thus job site overhead costs (12-802.4b) charged direct to the contract are not included in the fixed overhead element of the Eichleay formula and the computed damages.

a. Variable overhead costs. Variable overhead costs should not be included in the unabsorbed overhead calculation. Variable overhead costs are those that fluctuate either directly or proportionately with some appropriate measure of direct costs, such as direct production labor hours, machine time or direct materials (see 9-703.2b). If direct production labor costs (or other comparable base costs) occur, variable overhead costs will arise from that direct labor (or other comparable base) cost. Small tools, production shop supplies, and certain types of fringe benefits will be in the overhead pool because the production labor occurs. If direct production labor costs are not incurred, then these overhead costs will not be incurred. The shifting of production labor effort to subsequent periods changes the size of the allocation base and thus affects the amount of variable costs. If the delayed contract effort were being performed as planned, variable costs would have increased due to the existence of variable effort associated with that contract. During a stop-work order (delay), the remaining variable overhead costs would still be associated with other work. Thus, the stop-work order does not change the allocability of these costs to other work, as they are still associated with other production. The delayed work, if performed as planned, would have generated additional costs - more shop supplies, more small tools, or other variable costs in the period when performed.

For example, a contractor, with Contract Y being performed as planned, had $1 million of variable overhead costs and a direct cost base of $5,000,000. The variable rate is 20% ($1,000,000/$5,000,000 = 20%). If $1 million of Contract Y's base costs are eliminated (delayed for a year) the 20% variable costs associated with that contract would not be incurred. Instead of having $1 million of variable costs, there would only be $800,000. The variable rate on other work would not increase ($800,000/$4,000,000 = 20%).

b. Semi-variable costs. Semi-variable costs are those that are a combination of variable and fixed costs. For example, electricity costs include a line charge, which is fixed, and usage charges that are primarily variable. The variable portion of these costs should be excluded from the fixed overhead pool used in the Eichleay formula.

c. Fixed or Variable. To determine if a cost is variable or fixed, consider what would happen to those costs if the size of the performance base changed. Those costs related to laid off labor (for example, social security taxes and health insurance) would cease. They would

not be incurred nor be allocated to other contracts. During a period of delay, the social security taxes and health insurance in the pool are associated with other contracts and not to the delayed contract.

d. Relevant range. The concept of "relevant range" refers to the range of operations activity within which assumptions relative to fixed or variable costs are valid. For example, the total of a fixed cost is constant for the relevant range of production of 1 to 30,000 units of production. However, the total of a variable cost increases as the units of production increases from 1 to 30,000.

12-804.4 Delay Days

In All State, the court ruled that contractors may recover "Eichleay damages" for the period by which the overall performance of the contract is extended because of the Government-caused delay/suspension. Therefore, "delay days" for the purpose of computing unabsorbed overhead using the Eichleay formula are:

The additional days of performance because of a Government-caused delay added to the original or previously revised contract performance completion date. For example, the original contract performance period was 70 days but after the first 50 days of performance, the Government caused an indefinite delay that turned out to be 20 days. The extended period, beyond the scheduled completion date, that occurred due to the delayed work was 15 days, and the total actual performance period was 85 days. Therefore, "delay days" for computing the Eichleay formula would be 15 days (85 days – 70 days), the period of extended performance of the delayed work after the original contract performance completion period (there were no modifications to the completion date).

- Only the extension days resulting from a Government-caused delay/suspension. A contractor who was delayed and on indefinite standby for 15 days may, because of other factors such as inefficiency, finish the contract 20 days after the contract completion date. Fifteen of the extension days were due to a Government-caused delay and 5 days were caused by the contractor's inefficiency. In such a case, the 15 extension days caused by the Government delay are those that are used in the Eichleay formula as "delay days."
- Zero if the delayed/suspended contract work is completed within the original or revised performance period for purposes of computing Eichleay damages. There is one exception. If the contractor can show that, from the inception of the contract, it (1) intended to complete the contract early, (2) had the capability to do so; and (3) actually would have completed early but for the Government's actions, then unabsorbed overhead can be recovered for the delay period.

12-804.5 Eichleay Formula Example

The following example computes unabsorbed overhead using the Eichleay formula (12-804.1). Assume that a contractor has three contracts over a two-year period. Contract Y was scheduled to be performed in its entirety during the 365 days in calendar year 20X1, but was delayed 365 days, and the performance period extended to the end of 20X2. Contract Z was performed in 20X1, and Contract M was performed during the 365 days of 20X2. Also, assume that:

- Fixed overhead was $110,000 per year.

- Contract Y total billings (revenues) were $598,400.
- Total Billings (revenues) for 20X1 totaled $726,000 and $671,000 for 20X2.

Eichleay Formula Computations
Step 1. (Fixed) Overhead Allocable to the Contract:
$598,400/$1,397,000* = 43% x $220,000** = $94,600 *(20X1 Billings $726,000+ 20X2 Billings $671,000 = $1,397,000) ** (Fixed) Overhead Per Year = $110,000 x 2 Years Total Performance Period of Contract Y = $220,000
Step 2. Daily Contract (Fixed) Overhead Rate:
$94,600/730 days*** = $130 *** Total Performance Days of Contract Y= 365 x 2 = 730
Step 3. Unabsorbed Overhead
$130 x 365 days = $47,450

12-805 Audit Approach to the Eichleay Formula

The contractor's computation of unabsorbed overhead damages using the Eichleay formula should be audited. Objectives of the audit of proposed or claimed Eichleay formula damages include:

(1) providing financial analysis concerning the contractor's computed Eichleay damages and

(2) identifying information potentially useful to the contracting officer in making entitlement determinations.

The following steps should be completed:

- Perform audit of Eichleay formula components (12-805.1).
- Identify contractor modifications to basic Eichleay formula (12-805.2).
- Determine credits to formula results (12-805.3).
- Assess the impact of replacement contract(s) or other substitute work (12-805.4)

12-805.1 Audit of Eichleay Components

Audit the contractor's submitted Eichleay formula damages. The audit of Eichleay formula components consists of examining:

(1) contract billings and total contract (company) billings,

(2) total fixed overhead incurred during the period of performance,

(3) total performance days,

(4) the "delay days," and recomputing the Eichleay formula based on the results of (1) – (4).

These components are the basis of the computations contained in the three steps of the Eichleay formula, as shown in 12-804.1. In addition, see 12-805.2, for guidance on contractors' modification of the basic Eichleay formula.

a. Contract and Total Billings. Evaluate the contract and total billings in the contractor's Eichleay formula computation using the following audit procedures:

(1)Verify that the billings data used in the allocation ratio are accurate and appropriate. Be alert for modifications of the Eichleay formula as discussed in 12-805.2. If the contractor uses an allocation base other than contract billings to develop an allocation ratio (see Step 1, 12-804.1) e.g., contract labor/total labor, compare this ratio with the Eichleay formula's billings allocation ratio.

(2) Recompute the proposed Eichleay formula using the billings ratio unless the impact of a different measurement allocation base is immaterial, or unless the contractor can demonstrate that the established Eichleay allocation ratio would lead to inequitable results. Show the computations in the audit report and explain how the contractor's allocation base is materially different and results in an inequitable recovery of damages.

(3) Evaluate the contractor's method for recognizing revenue (billings). Determine if it results in an inequitable allocation of unabsorbed overhead. When the percentage-of-completion method is used, consider the acceptability of the assumptions used to measure the extent of progress towards completion. Overstatement of the percentage of completion of the delayed contract (contract billings) or understating the percentage of completion of the other contracts (total billings for the contract period) in the Eichleay formula (refer to Step 1, 12-804.1) can result in overrecovery of unabsorbed overhead. If the allocation ratio (contract billings/total billings) is overstated, the computation overstates fixed overhead allocated to the delayed contract. The delayed/suspended contract and total billings may also be overstated by including deleted or terminated work or unexercised options pertaining to other work in the total billings denominator of Step 1. The delayed contract and total billings may be understated by excluding settled claims and reasonable estimates of undefinitized work and modifications.

b. Total Fixed Overhead Incurred During Contract Performance Period. Examine the overhead costs in the contractor's Eichleay computation and remove all variable cost items in Step 1 of the Eichleay formula (R. G. Beer Corp, ENGBCA No. 4885, 86-3 BCA 19,012) (see 12-804.1) using the following audit procedures.

(1) For construction contracts, the fixed overhead costs included in the Eichleay formula are home office overhead costs for the entire contract performance period. Site indirect costs are not included. For manufacturing/supply contracts, analyze the overhead accounts comprising the total overhead incurred during the contract performance period including general and administrative and other indirect overhead costs. Overhead accounts identified as containing potentially variable costs may initially be selected based on the nomenclature or account description. However, such a basis for selection is often insufficient to make a final determination. The auditor should examine the costs in the account and supporting invoices as necessary to determine their variability in relation to some operations activity or measure of production, such as direct labor or direct materials. Also consider the "behavior" of the cost items over the selected relevant range of operations activities (refer to 12-804.3). The auditor may consider the use of graphic analyses and computational techniques to gain insight into the behavior of costs as fixed, semi-variable, or variable. Techniques of graphic and computational analyses are discussed in Appendix E. The audit report should explain the basis for proper classification.

(2) The following are examples of manufacturing/supply contractor overhead accounts selected on a nomenclature basis as potentially variable, along with comments on what to evaluate to ensure that the costs are correctly determined to be either fixed or variable. The audit report should include a discussion of the categories of overhead costs determined to be variable and the basis for that determination.

Account Title	Comments
Payroll taxes, vacation and holiday pay	Determine the amount allocable to variable labor.
401 K pension plans and group insurance	Determine the amount allocable to variable labor. Administrative fees would be considered fixed costs.
Equipment rental	The costs would be fixed if rental agreements are long term. For short-term leases, determine type and use of equipment as related to efforts of variable labor.
Uniforms	Determine if the costs are related to variable labor. Uniforms for maintenance workers or security guards are usually fixed.
Vehicles	For vehicles used by variable labor, gas and oil are operating costs that would be classified as variable costs. To the extent that gas and oil are used for work that is of a fixed nature, they are fixed costs. Maintenance and repairs are normally semi-variable. If the vehicles were leased, long-term leases would be fixed.
Shop supplies and welding supplies	Determine the types of costs in the accounts. Usually these costs are variable because usage depends on variable labor. The fact that there are stock-up purchases does not detract from variability.

(3) Ensure that unallowable costs per FAR 31are removed from the fixed overhead pool as required by applicable contract provisions. Refer to CAM Appendix A.

c. Performance Days. Ensure that the entire performance period is used in the Eichleay formula, including the original performance days, previous time extension modifications, and extended performance days. See 12-804.1 for further discussion.

d. Delay Days. Determine how the contractor computed the "delay days" used in its Eichleay formula computation. All proposed or claimed "delay days" must be attributable to Government-caused suspension and not include any contractor-caused delay days. Request technical assistance to determine the appropriate delay days. The existence and the impact of issues such as contract modifications, contractor-caused delays and early completion on the appropriate delay days can be complex and therefore require technical expertise. To assist the CO in addressing entitlement issues, include any evidence relevant to the appropriate delay days in the audit report notes on the audit of the Eichleay formula. See 12-804.4 for further guidance.

e. Recompute the Eichleay Formula. Recompute the Eichleay formula using the results of a. – d. Question the difference between the contractor's computation and the results of audit. Provide the contractor's computations and the audit computations of the Eichleay formula in the audit report with explanations for the questioned costs.

12-805.2 Contractors' Modifications to the Basic Formula

a. Modifications to Eichleay Formula. Identify contractor modifications to the components of the basic Eichleay formula (refer to the results of the audit of the formula in 12-804.1). Often these modifications result in excessive recovery of unabsorbed overhead and duplicate recovery of the claimed costs or contract performance costs included in the original contract price. Modification of the Eichleay formula does not conform to the court-established formula (Satellite Electric Co. vs. Dalton, 105 F.3d 1418 (Fed Cir. 1997)) (see 12-804.1). The auditor should determine if the modification results in significant excess costs over that computed using the basic Eichleay formula. Be aware that a contractor may use a modified Eichleay formula in a proposal or claim but fail to label it as "modified."

b. Common Modifications. Some of the most common modifications encountered include:

- Use of original contract price as opposed to actual contract billings (revenues) in the numerator of Step 1 of the basic Eichleay formula (see 12-804.1).
- Original (or planned) days of performance as opposed to complete performance period in the denominator of Step 2 (see 12-804.1). Other formula components, total billings and fixed overhead should also be for the complete time interval (see 12-804.1).
- Actual delay or suspension days rather than extension days beyond the original or revised completion date (see 12-804.4).

c. Effects of Modifications. Modifications to the components of the formula as discussed in b. distort the premises underlying the basic Eichleay formula. For example, substituting original contract price in place of contract billings, or original performance periods in place of the entire period of performance, prevent the formula's basic logic of allocation to performance and delay periods from operating properly (see 12-805.1a).

12-805.3 Credits to Eichleay Results

Adjust the Eichleay formula computed damages when the contractor has been reimbursed for or has proposed or claimed fixed overhead applied to proposed or claimed direct costs or any change order work or out-of-sequence work on the delayed/suspended contract performed during the same period (suspension and extension periods) covered in the Eichleay formula (R. G. Beer Corporation, ENGBCA No. 4885, 86-3 BCA 19,012 and Excavation Construction Inc., ENGBCA No. 3851, 84-3) (see 12-805.4 for additional guidance on additional change order or out-of-sequence work on the delayed contract). Otherwise, there would be duplicative recovery of the same fixed overhead. Credit the Eichleay formula results for any fixed overhead that the prime contractor applied to a subcontractor's proposed or claimed unabsorbed overhead.

12-805.4 Assess the Impact of Replacement Contract(s) or Other Substitute Work

a. Replacement or Substituted Work. Examine the contractor's records to determine if the contractor performed any replacement contract(s) or other substitute work during the period from the start of the alleged delay/suspension period through to the end of the extension period. In Melka Marine v. U.S., 187 F.3d 1370 (Fed. Cir. 1999), the court held that if replacement work absorbed the same amount of overhead as the delayed/suspended contract would have absorbed had there been no delay, all Eichleay damages would be precluded. Nonetheless, the auditor should compute the impact of the replacement contract as discussed below. If the replacement work did not fully absorb all of the overhead that the delayed/suspended contract would have absorbed had there been no delay, Eichleay damages would be limited to that amount of overhead not absorbed by the replacement contract. Therefore, assess the amount of overhead actually allocated to any replacement contract(s) or other substituted work (accelerated work on other contracts) performed and adjust the results of the Eichleay formula damages. Evidence of the contractor's efforts to reduce or eliminate delay/suspension damages can assist the contracting officer in addressing whether it was practicable for the contractor to take on any replacement work during the delay/suspension period and rebutting the contractor's entitlement to Eichleay damages (see 12-804b).

The argument is sometimes made that the Eichleay formula already reflects the impact of replacement contract work in the results of the formula computations because it is included in the denominator of the billings ratio (see 12-804.1a). This contention, however, is generally not correct. The Eichleay formula recognizes only a fractional portion of most types of replacement work or other substitute work that would absorb a portion or all of the fixed overhead normally allocated to the delayed contract labor or other costs. For example, if the contractor replaced all of the delayed work, the Eichleay formula (if computed) would still show unabsorbed overhead even though the replacement work was included in the denominator (total billings) of the allocation ratio (see Step 1, 12-804.1). This is because the numerator of the allocation ratio (contract billings) does not decrease, regardless of the size of the replacement contract or substituted work. The numerator would have to decrease to zero for 100 percent replacement to be adequately reflected in the Eichleay formula. The replacement work or other substitute work included in the denominator of the allocation ratio (total contract billings) only fractionally affects the formula results.

b. Replacement Contract. If a contractor is able to obtain a replacement contract(s), such work absorbs a portion of the fixed overhead that otherwise would have been allocated to the delayed work. Replacement contracts (Government and commercial) are contracts with work that would not have been obtained and performed had there been no delay. In Melka Marine, Inc. v. U.S., 187 F.3d 1370 (Fed Cir. 1999), the court described a replacement contract as work different in either size, duration, or type from the delayed/suspended contract. For example, a construction contractor may obtain a replacement contract for performing repairs (different type) in contrast with the delayed/suspended construction contracts. Also a contractor may obtain a replacement contract for a smaller scope of work than the delayed/suspended contract. All contracts obtained and performed during the delay/suspension and/or extension periods should be evaluated as potential replacement contracts. Replacement contracts should be specifically identified in the audit report. This identification should include the date of award, contract number, performance period, amount of the contract, the

type of effort, duration or size (contrasted with that of the delay/suspended contract), and location. Information on all contracts performed during the delay/suspension and extension periods should be available, as part of the contractor's evidence for showing that it was impractical to obtain replacement work.

c. Other Substitute Work. Other substituted work includes significant work performed out-of-sequence on the delayed contract (All Seasons Construction & Roofing, Inc., ASBCA No. 45583, 98-2 BCA ¶30,061), substantial additional or change order work on the delayed contract (Safeco Credit and Fraley Associates v. U.S., 44 Fed. Cl. 406 (Fed. Cl. 1999)); or acceleration of other contract work (manufacturing/supply contracts) (Libby Corporation, ASBCA Nos. 40765 and 42553, 96-1 BCA ¶28255, affirmed without opinion CAFC 96-1351 (1997)). Evidence of other substituted work should be specifically identified in the audit report. The discussion of out-of-sequence work performed on the delayed contract should include the percentage of the out-of-sequence work to the total dollar amount of work, a performance schedule of out-of sequence tasks as planned, a schedule of the tasks as actually performed, and a general description of the work performed. The discussion of additional or change order work on the delayed contract should include the date and number of the change order/ modification, the type of work performed, the dollar amount of the work, and the date(s) that the work was performed. The discussion of accelerated work should include the date of award, contract number, a schedule of work as planned, a schedule of work as actually performed, total amount of the contract, and the type of accelerated work.

d. Indications of Replacement or Other Substitute Work. Several indicators can suggest the possibility of replacement contract(s) or other substituted work. The auditor may observe from analyzing labor registers that personnel from the delayed/suspended contract were assigned to other contracts during the delay/suspension period. An analysis of fixed overhead rates during the delay/suspension and extended performance period may show that these rates decreased, or were unchanged. New contracts for work not normally performed by the contractor might be added during the delay/suspension and extension periods. Also, a construction contractor may perform a significant number of tasks out-of-sequence from the performance schedule as planned. A review of the work schedule as planned or the critical path schedule may provide evidence of such changes.

In such circumstances, the auditor should ascertain whether this work would still have been performed had the delay/suspension not taken place. For a manufacturing concern, plantwide production schedules from time periods preceding the delay can be compared with actual production schedules. If the other work is not on the earlier production schedule, the auditor should examine the circumstances under which such work was obtained, and whether the acquisition or acceleration of the work preceded the delay. Correspondence files of the other work may indicate a cause-and-effect relationship between its acquisition or performance, and the delay/suspension on the subject contract. In a manufacturing environment, the auditor can also meet with production personnel, and examine production floor notes and records to obtain a better understanding of the other work and the circumstances under which it was acquired. Technical assistance may be required to ensure correct interpretation of the work schedule data.

e. Assess the Impact. When there is evidence of replacement contracts or accelerated work on other contracts, out-of-sequence and/or additional work on the delayed contract, the Eichleay formula damages must be adjusted. For additional work or out-of-sequence work on the delayed contract, perform Steps (1) – (3) as shown below and adjust the re-

sults of the audited Eichleay formula per 12-805.3. For replacement contracts and/or accelerated work on other contracts perform Steps 1-9 as shown below to assess the impact.

The following is an example for assessing the impact of a replacement contract:

Home office (fixed) overhead costs were approximately $600,000 per annum for XYZ Construction Inc. Contract A with a $500,000 fixed cost allocation base including site overhead was scheduled to be performed from 1/1/1997 through 12/31/1997. However, the Government delayed the contract for 365 days (delay period 1/1/1997 – 12/31/1997). The contractor was able to start working on the contract on 1/1/1998 and completed the work on 12/31/1998 (extended performance period). Other contracts scheduled to be performed during the period included:

Contract B with a $450,000 cost allocation base (including job site overhead) was scheduled to be performed 1/1-12/31/98. However, because of the delay in the performance of Contract A, Contract B could not be started until 1/1/1999. Contract C with an allocation base of $550,000 (including job site overhead) was performed as scheduled 7/1/97 – 6/30/98. Contract D with an allocation base of $80,000 (including job site overhead) was a replacement contract for Contract A and was performed 11/1/97 – 1/15/98. All contracts were firm-fixed-priced.

Perform the following steps:

(1) Determine the contractor's actual fiscal year fixed cost allocation base(s) for the entire performance period of the delayed contract including the period when the replacement work or other substituted work was performed (the applicable delay/suspension and/or extension periods). Also, determine the fixed cost allocation base of the replacement contract(s) or other substituted work.

Actual 1/1/1997 – 12/31/98

	Contract A	Contract B	Contract C	Contract D	Total
Actual Fixed Cost Overhead Allocation Base	$500,000	$0	$550,000	$80,000	$1,130,000

(2) Compute the actual fixed overhead costs allocated to the fiscal year fixed cost allocation base(s) for the entire performance period of the delayed contract including the period when the replacement contract(s) or other substituted work was performed.

The fixed overhead costs are computed as follows:

	Actual	
	1997	1998
Contract A Allocation Base	$0	$500,000
Contract B Allocation Base	$0	$0
Contract C Allocation Base	$275,000	$275,000
Contract D Allocation Base (Replacement Contract)	$64,000	$16,000

Total (a)	$339,000	$791,000
Total Fixed Overhead (b)	$600,000	$600,000
Actual Fixed Overhead Rates (b)/(a)	176.99%	75.85%

Contract fixed overhead per fiscal year = Base x fiscal year fixed overhead rate.

	Actual		
	1997	1998	Total
Contract A Fixed Overhead	$0	$379,250	$379,250
Contract B Fixed Overhead	$0	$0	$0
Contract C Fixed Overhead	$486,723	$208,588	$695,311
Contract D Fixed Overhead (Replacement Contract)	$113,274	$12,136	$125,410
Total Fixed overhead (b)	$599,997	$599,974	$1,199,971*

*Difference due to rounding.

(3) Determine the amount of actual fixed overhead applicable to the replacement contract(s) or other substituted work.

Actual Fixed Overhead Allocated to the Replacement Contract D = $125,410

(4) Use the audited Eichleay formula damages (see 12-805.1).

The following represents the audited Eichleay formula based on the example discussed above.

Eichleay Formula Computations
Step 1. (Fixed) Overhead Allocable to the Contract: $ 967,175/$2,563,000* = 38% x $1,200,000 = $456,000
Step 2. Daily Contract (Fixed) Overhead Rate: $456,000/730 days** = $625
Step 3. Unabsorbed Overhead $625 x 365 days*** = $228,125

*Contract A billings: $500,000 Overhead Allocation Base + $379,250 Fixed Overhead + $87,925 10% profit = $967,175
Total billings: $1,130,000 total overhead cost allocation base + $1,200,000 fixed overhead +$233,000 10% profit = $2,563,000
** Total Performance Days of Contract A= 730
*** Period of extended performance beyond the original completion date of 12/31/97, 1/1/98 – 12/31/98 = 365 days.

(5) Determine the billings of the replacement work from the total billings element of Step (4).

	Actual		
Replacement Contract D Billings	1997	1998	Total
Fixed Cost Allocation Base	$64,000	$16,000	$80,000
Allocated Fixed Overhead (Step 2)	$113,274	$12,136	$125,410
Subtotal	$177,274	$28,136	$205,410
Profit @ 10% (Step 4)	$17,727	$2,814	$20,541
Billings	$195,001	$30,950	$225,951

(6) Remove the replacement contract billings from the total contract billings element of the Eichleay formula and recompute the formula damages.

Eichleay Formula Computation without Replacement Contract
Step 1. (Fixed) Overhead Allocable to the Contract: $ 967,175/$2,337,049* = 41% x $1,200,000 = $492,000
Step 2. Daily Contract (Fixed) Overhead Rate: $492,000/730 days** = $674
Step 3. Unabsorbed Overhead $674 x 365 days*** = $246,010

*Contract A billings: $500,000 Overhead Allocation Base + $379,250 Fixed Overhead + $87,925 10% profit = $967,175
Total billings: $1,130,000 total overhead cost allocation base + $1,200,000 fixed overhead +$233,000 10% profit = $2,563,000 less replacement contract D billings $225,951 (Step 5) = $2,337,049
** Total Performance Days of Contract A= 730
*** Period of extended performance beyond the original completion date of 12/31/97, 1/1/98 – 12/31/98 = 365 days.

(7) Compute the impact of the replacement work on Eichleay formula damages.

Eichleay formula computed without replacement work (Step 6)	$246,010
Eichleay formula damages (as audited) (Step 4)	-$228,125
Impact of replacement work reflected in the Eichleay formula computed damages	$17,885

(8) Compare the actual fixed overhead allocated to the replacement contract or other substituted work (Step 3) to the impact of replacement work reflected in the Eichleay formula computed damages (Step (7). Question any significant differences between the Eichleay formula damages and the amount of the fixed overhead applicable to the replacement contract(s) and other substituted work.

Comparison:

Actual fixed overhead allocated to the replacement contract (Step 3)	$125,410
Impact of replacement work reflected in the Eichleay formula computed damages (Step 7)	-$17,885
Impact of replacement work not reflected in the Eichleay formula damages	$107,525

(9) Question the impact of replacement work or other substituted work not reflected in the Eichleay formula damages.

Eichleay formula damages as audited (Step 4)	$228,125
Questioned costs: Impact of replacement work not reflected in the Eichleay formula damages (Step (8)	$107,525
Difference	$120,600

12-806 Presenting the Results of Audit of the Eichleay Computations

The audit report presentation of the results of audit of the Eichleay formula should include the contractor's computations, the audit computations and a discussion of the basis for the differences by each element of the formula. In addition, the report should include an assessment of the delay damages that separately analyzes the net impact of replacement work or other substituted work.

The following is a suggested format for showing the results of audit of the contractor's Eichleay formula computations, the determination of credits and replacement work.

		Questioned Costs Notes
Contractor's proposed Eichleay damages	$XXXX	
Audit computed Eichleay damages (after adjusting for formula errors) (12-805.1 - 2)	XXXX	
Questioned costs due to errors in contractor's computation of Eichleay damages		$XXX
Credit for fixed overhead on proposed or claimed direct costs or additional work (12-805.3)		X
Net impact of the replacement contract(s) not reflected in the Eichleay formula computed damages (12-805.4)		XX
Total questioned costs		$XXX

The notes should show all computations and the rationale for the adjustment to the contractor's price adjustment proposal or claim.

12-807 Total Cost Method for Pricing Equitable Adjustments

a. The total cost method is sometimes used by contractors as a basis for determining the cost of an equitable adjustment. Under the total cost method, a price adjustment represents the difference between the total cost upon which the contract price was based and the costs actually incurred in contract performance. This method does not consider that the bid may have been too low or that the additional costs may have been for reasons which are the responsibility of the contractor. To use this method, the contractor should prove that (1) the nature of the delay/disruption makes it impossible or highly impracticable to directly determine actual delay costs with a reasonable degree of accuracy, (2) the bid was realistic, (3) the actual incurred costs were reasonable, and (4) the Government was responsible for the differences between bid and incurred costs.

b. Total cost method calculations are often modified to eliminate some of the inherent inaccuracies found in the total cost method. This is the modified total cost method. The contractor may adjust the original bid and the actual performance costs to remove inaccurate bid costs or add in costs explicitly excluded in the original bid. Also, costs that are the responsibility of the contractor (contractor-caused delays) or are not the responsibility of the Government are removed from the actual costs. However, there is a risk that the contractor did not eliminate all costs that are not the responsibility of the Government. Most of the objections of the total cost method remain. See 12-704 for further guidance on the audit of the total cost method or the modified total cost method.

12-808 Loss of Efficiency

a. A contractor's request for damages for loss of efficiency or productivity relates to additional direct costs for material, equipment usage, and labor productivity and the associated indirect costs caused by actions or inactions of the Government. The loss of efficiency can be caused by acceleration of work, the addition of unscheduled work, or the disruption or delay of contract performance as scheduled. When there is a loss of efficiency caused by a delay in completion of the contract, the entitlement and quantum for the loss of efficiency are a separate element from the additional direct costs and unabsorbed overhead delay damages. However, auditors should be alert to any duplication of recovery of the same costs for loss of efficiency and delay damages.

b. The following are some of the causes of loss of efficiency that relate mainly to construction contracts but which may also relate to production contracts:

- Adverse weather conditions
- Adverse job site conditions
- Restricted access to a jobsite
- Excessive safety inspections
- Excessive change orders
- Overtime on an extended basis
- Out of sequence work
- Out of scope work

When a contractor is forced to perform work incompatible with adverse weather conditions due to Government actions or inactions (for example, performing welding tasks out-of-doors during winter weather), the contractor's costs for loss of labor efficiency may be recoverable. Also, adverse job site conditions such as unexpected water seepage on a con-

struction site, may cause loss of labor and equipment efficiency in performing certain operations. Assessment of the contractor's asserted damages under these circumstances and others will require a technical evaluation. Auditors should review the contractor's insurance policies for possible coverage of the damages to preclude duplicate recovery.

c. The contract clauses generally used as the basis of the equitable adjustment include the Changes Clause (FAR 52.243-1), Changed Conditions (FAR 52.243-5), Suspension of Work (FAR 52.242-14), and Differing Site Conditions (FAR 52.236-2). Review the contract to determine whether it contains a clause that denies the contractor any right to recover damages because of a hindrance or delay in the progress of the contract work.

d. Methods of computing the quantum basis of recovery include:

- Total cost or modified cost (see 12-704)
- Factors applied to direct labor, materials or equipment
- Should cost analysis compared to actual costs

Contractors may compute their damages by applying factors based on industry-wide studies or standards, expert opinions, or should cost analysis compared to direct labor hours, material quantities or equipment usage that require technical evaluation. When the proposal or claim consists exclusively of damages for loss of efficiency, the auditor should propose to the contracting officer that the engagement be conducted as an agreed-upon procedures evaluation. For example, under an agreed-upon procedures evaluation, the auditor can verify the direct labor rates applied to additional labor hours estimated using a factor(s) that is evaluated by a technical specialist. Any adjustments (potential offsets) to the proposed or claimed amounts that are based on the procedures applied should be shown in the audit report (refer to 10-1101b).

12-900 Section 9 --- Claims for Extraordinary Relief

This section discusses claims seeking extraordinary relief under 50 U.S.C. 1431-1435 (Public Law 85-804, as amended).

a. The provisions of 50 U.S.C. 1431-1435 give the President power to authorize Government departments and agencies to enter into, amend, or modify contracts, without regard to other laws related to making, performing, amending, or modifying contracts, whenever such action would facilitate the national defense.

b. Executive Order 10789, November 14, 1958, authorizes Government departments and agencies to exercise the contracting authority given by 50 U.S.C. 1431-1435.

c. FAR Part 50 sets forth the policies and procedures for contract adjustments under 50 U.S.C. 1431-1435.

d. Examples of contract adjustments previously made under 50 U.S.C. 1431-1435 include:

(1) When loss under a contract impairs the contractor's ability to perform or act as a source of supply under a contract that is essential to the national defense, there may be an amendment without consideration.

(2) Amendment or modification to correct or mitigate a mistake.

(3) Amendment to formalize informal commitments to a person who took action without a formal contract.

e. In addition to the specific cost information required for individual submissions, consider the following for use in the audit and/or report, particularly for claims brought under 50 U.S.C. 1431-1435:

(1) The contractor's financial position based on the most current information available, and the potential effect on that position if contract performance continued to completion.

(2) Net working capital changes and changes in financial position since starting the contract.

(3) A comparative statement of costs experienced under the contract and other similar production.

(4) The estimated costs to complete the contract.

(5) The compensation paid to the contractor's key personnel.

(6) The extent of financial assistance furnished by the Government (such as V-loans, advances, progress payments, and facilities).

(7) Segregation of the profit-and-loss statement between commercial and Government business.

(8) Any legal proceedings pending against the contractor.

(9) Any unusual factors which may impair the contractor's ability (financial or other) to perform the contract.

(10) Contract inventories and their value in case of default.