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President's Column

Peter A. McDonald
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This is my last President's Column.

This past year has been a very worthwhile experience. My sincere thanks go to the many, many people who have given willingly of their time to support BCABA activities, and I am very grateful to them all: officers, governors, committee chairs, and dozens of members. My many thanks also go to all the BCA judges who voluntarily participated in our meetings.

Over the last year, these combined efforts contributed to the vitality of the BCABA and resulted in organizational growth, both in our individual memberships as well as our Gold Medal firms. Also on the plus side, our ratio of government attorneys remained about the same. This will be seen in the FY 2003 Directory, to be published and distributed next month.

My last project will be to revamp our rules of governance by updating our constitution and by-laws to reflect our actual practices. These proposed changes have been distributed to the Board of Governors (two changes to the constitution, and sixteen changes to the by-laws). With their approval, the membership will vote on these changes at the annual meeting [*Editor's Note: See page 43*].

I hope to see many of you at our annual meeting on October 23rd at the Army-Navy Club.

Editor's Column

Clarence D. "Hugh" Long, III

This month we have another set of timely articles. We have two articles on problems in the accounting industry. This industry is now facing some of the problems traditionally faced by lawyers, and like lawyers, the problems were caused by people who took shortcuts. One article, by Steve Knight, describes how accountants can possibly be made to report on their clients. The other article, by Pete McDonald and Paul Pompeo, describes the new audit standards for fraud and how those standards will affect accountants, clients and government auditors.

We also have an extremely well thought out article by Judge Stephen Daniels on the problems caused by the largely successful attempts to streamline the procurement process in the last decade or so. The idea was, to some extent, to get lawyers out of the system. But at some point that created its own problems, as Judge Daniels points out.

Pete McDonald has contributed his draft of proposed changes to the Constitution and bylaws. All members are urged to read these with care and to contribute their thoughts to the Board of Governors, who will be voting.

Frank Peterson has written an excellent article on the difference between allocability and allowability, as defined by the recent *Boeing* decision. Rounding out this issue, Christopher Yukins has given us an informative article on the Canadian protest process.

Annual Meeting

The BCABA annual meeting will be held on October 23rd at the Army-Navy Club on Farragut Square in Washington, D.C. You will soon receive an announcement.

**'Recovery Auditing' and 'Overpayments':
New Law Casts Contractors as Auditors and Agencies as Bounty
Hunters**

**by
Stephen D. Knight***

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The terms "recovery audits" and "recovery activities" may be unfamiliar to many contractors and procuring agencies, but they will soon work their way into contracting jargon--and with hidden surprises, some of them unpleasant. A new layer of bureaucracy will be employed to ferret out suspected "overpayments"--a term broad enough to encompass most government claims. While the program is modeled on private sector initiatives, the manner of implementation will diverge from that followed in the private sector. Thus, the structure of the program makes it suspect from the outset. In addition, it is by no means clear the government will gain any benefit from this new round of red tape to be imposed on its contractors.

In any case, federal contractors should educate and prepare themselves now, for they will soon have to contend with increased audit scrutiny resulting from a number of statutory and regulatory changes, along with new audit guidance from the Defense Contract Audit Agency ("DCAA"). While these changes may appear innocuous, they hold the potential for imposing additional duties and penalties on companies doing business with the federal government.

I. The New Recovery Audit Legislation

Congress has passed legislation that requires agencies to use "recovery audits" and "recovery activities" to "recover amounts erroneously paid to contractors." The task of defining these terms and issuing regulations is the responsibility of the Director of the Office of Management and Budget ("OMB"). The legislation, however, fails to take into

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account provisions in the Federal Acquisition Regulation ("FAR") that impose restrictions and requirements on government claims for overpayments. The legislation, moreover, creates questionable incentives for auditors performing the recovery audits and agencies for which the audits are performed. Ultimately, contractors will be forced to deal with the untenable situation Congress has created in the National Defense Authorization Act for Fiscal Year 2002, Pub.L. No. 107-107, §831 ("FY '02 DOD Act" or "the Act").

Contained in §831 of the FY '02 DOD Act is a provision entitled "Identification of Errors Made by Executive Agencies in Payments to Contractors and Recovery of Amounts Erroneously Paid." This section requires every executive agency that enters into contracts with a total value in excess of \$500 million during a fiscal year to "carry out a cost-effective program for identifying any errors made in paying the contractors and for recovering any amounts erroneously paid to the contractors." Congress now requires each such agency to use "recovery audits" and "recovery activities" as a part of the agency's program, and further requires the agency head to "determine, in accordance with guidance provided [by the Director of the Office of Management and Budget under § 831 of the Act] the classes of contracts to which recovery audits and recovery activities are appropriately applied."

Congress, however, left to OMB the task of defining the terms "recovery audits" and "recovery activities" and the classes of contracts to which they will apply. The Act requires the Director of OMB to issue guidance on:

- (1) definitions of "recovery audit" and "recovery activities";
- (2) the classes of contracts to which recovery audits and recovery activities are appropriately applied;
- (3) protections for the confidentiality of sensitive financial information that has not been released for use by the general public, and information that could be used to identify a person;
- (4) "policies and procedures for ensuring that the implementation of the [agency] programs does not result in duplicative audits of contractor records";
- (5) policies regarding the contract types executive agencies may use for procuring recovery services, "including guidance for use, in appropriate circumstances, of a contingency contract pursuant to which the head of an executive agency may pay a contractor an amount equal to a percentage of the total amount collected for the United States pursuant to that contract";
- (6) protections for a contractor's records and facilities "through restrictions on the authority of a contractor under a contract for the procurement of recovery services";
 - (a) to require "the production of any record or information by any person other than an officer, employee, or agent of the executive agency";
 - (b) to have a physical presence on the property of any private sector entity for the purposes of performing the contract; or

(c) "to act as agents for the Government in the recovery of funds erroneously paid to contractors."

In other words, Congress has imposed an additional layer of audits on contractors and left to OMB the task of defining the nature, scope, and manner of implementation of these audits.

Congress also mandated the disposition of any monies recovered through the recovery audits and recovery activities. Funds collected "shall be available to the executive agency...[t]o reimburse the actual expenses incurred by the executive agency in the administration of the program" and "[t]o pay contractors for services under the program" in accordance with OMB guidance on the use of contingency contracts. Any unused funds "shall be credited to the appropriations from which the erroneous payments were made, shall be merged with other amounts in those appropriations, and shall be available for the purposes and period for which such appropriations are available; or if no such appropriation remains available, shall be deposited in the Treasury as miscellaneous receipts."

In addition, agency heads must consider resources available to perform the agency's recovery audit and recovery activities program from "the executive agency," "other departments and agencies of the United States," and "private sector sources." However, before entering into a contract with a private sector source for the performance of a recovery audit, the agency head must comply with OMB Circular A-76 and "any other applicable provision of law or regulation with respect to the selection between employees of the United States and private sector sources for the performance of services."

This legislation had its genesis three years ago in H.R. 1827, "Government Waste Corrections Act of 1999," introduced by Rep. Dan Burton (R-Ind.) on May 17, 1999. As explained in General Accounting Office ("GAO") reports, recovery auditing was a technique that used proprietary software to examine *an agency's data* to identify missed discounts, price discrepancies, duplicate payments, and other overpayments. GAO Report No. GAO/NSIAD-99-12, "Contract Management: Recovery Auditing Offers Potential to Identify Overpayments" (December 1998). GAO stated erroneous or improper payments were a problem under federal entitlement and assistance programs, as well as federal contracts. According to one GAO report, however, improper payments appeared to be more of a problem under *entitlement and assistance programs* than contracts. GAO Report No. GAO/AIMD-00-10, "Financial Management: Increased Attention Needed to Prevent Billions in Improper Payments" (October 1999).

Rep. Burton sought to apply recovery audit practices used in the private sector to "payment activities" within government agencies, but defined "payment activities" to focus *only* on executive agency activities that made payments to government contractors. H.R. 1827 also defined "recovery audit" to include auditing for overpayments resulting from "duplicate payments, pricing errors, failure to provide applicable discounts, rebates, or other applicable allowances, or charges or payments that are not authorized by law, regulation, or other applicable requirements."

Section 831 is fundamentally a bad idea and poses numerous problems for contractors. It provides no definition of "recovery audits" and "recovery activities." It aims those audits at federal contracts when, according to GAO, the overpayments problem exists primarily in the assistance and entitlement programs. Section 831 appears to provide for the audit of *contractor* records, rather than *agency* records - exactly the opposite of how recovery audits are used in the private sector. While H.R. 1827 was clearly objectionable in its overbreadth ("charges or payments that are not authorized by law, regulation, or other applicable requirements"), at least H.R. 1827 appeared to focus on agency payment activities.

The misplaced focus of §831 is underscored by the guidance Congress requires from OMB. In addition to defining the terms "recovery audit" and "recovery activity," OMB must provide guidance on "the classes of contracts to which recovery audits and recovery activities are appropriately applied." Had Congress followed through on the private sector model--its original goal--§831 would have required OMB guidance on *agency* records of payments made under defined classes of contracts entered into by the agency. Moreover, while §831 requires OMB guidance on protection of a contractor's records and facilities when a *private contractor/auditor* performs the recovery audit (protection with respect to production of records, presence on the contractor's property, and the private contractor/auditor's ability to act as the government's agent in recovery of funds), the Act does not call for similar protections when *government employees* perform the recovery audit. In short, the contractor is not protected with respect to these burdens when the recovery audit is performed by government employees. Clearly, the focus has shifted squarely to audit of contractor records.

Despite §831's requirement that OMB provide guidance to ensure against duplicative audits of contractor records, duplicative audits are nonetheless bound to result. Even if the OMB guidance should clarify that recovery audits apply only to agency records, the practical result will be for agency personnel to ask contractors for support in responding to the recovery audit requests for documentation and information. Contractors will bear the burden of the additional audits, either directly or indirectly.¹

Moreover, §831 fails to recognize the statutory, regulatory, and contractual processes already in place. Under applicable law, the contracting officer determines whether payments should be made to a contractor under a government contract. The government's various auditing functions, such as DCAA and agency Inspectors General, perform a variety of audits to examine whether contract prices are fair and reasonable, payments are made in accordance with contractual terms and conditions, and applicable cost accounting and cost allowability regulations are observed. With the aid of technical personnel, such as quality and audit personnel, the contracting officer determines whether the contractor's performance and delivery of goods and services is acceptable and whether payment under the contract is warranted. See FAR 52.215-2, 52.216-7, 52.216-16, 52.232-16.

If the contracting officer determines that payment is not authorized, the contracting officer withholds payment or asserts a government claim pursuant to the Contract Disputes Act, 41 U.S.C. §601 *et seq.* Section 831, however, makes no provision

for the coordination of recovery audits and recovery activities with established law concerning the assertion of government claims for improper payments.

Section 831 also fails to recognize the mandatory procedures of FAR 32.6. That section sets forth the requirements for the government to assert a debt against a contractor. FAR 32.602 provides examples of the ways in which contractor indebtedness can arise. FAR 32.602(d) and (f) explicitly address examples of overpayments. FAR 32.605(b) states in part: "For most kinds of contract debts...the contracting officer has the primary responsibility for determining the amounts of and collecting contract debt." FAR 32.606 provides additional, and specific, requirements concerning the government's determinations of contract debts. That regulation states in part:

(a) If any indication of a contract debt arises, the responsible official shall determine promptly whether an actual debt is due the Government and the amount....

(b) In determining the amount of any contract debt, the responsible official shall fairly consider both the Government's claim and any contract claims by the contractor against the Government...

In summary, FAR 32.6 sets forth specific requirements for the contracting officer, as the "responsible official," to assert a contract debt against the contractor. The contracting officer must determine the amount and collect the debt. In so doing, the contracting officer must consider the contractor's offsetting claims. Section 831 is silent on all these requirements. Further, §831 offers no clue as to how the undefined "recovery audits" and "recovery activities" are to be coordinated with the CDA requirement that contracting officers render final decisions on government claims against the contractor.

Other provisions of §831 are troublesome as well. For example, the Act sets up a "bounty hunter" mechanism for both the private contractor/auditor and the agency. Section 831 authorizes agencies to use "contingency contracts" under which an agency "may pay a contractor an amount equal to a percentage of the total amount collected for the United States pursuant to that contract." This built-in conflict will incentivize the private contractor/auditor to assert overpayments aggressively to boost its own returns. This program, substituting for independent, objective analysis, is bound to produce problems for contractors who will be forced to hire attorneys and accountants to combat the exaggerated or unfounded charges.

Yet, under the ignored FAR 32.6, "overpayments" must be determined in light of contractor claims against the government. What constitutes an "overpayment" and "the total amount collected for the United States" are significant open questions. By overlooking FAR 32.6 requirements, the agency will force the contractor to file its *own* claim to challenge the validity of the recovery audit and recovery activity.

Section 831 also sets up the agency as a "bounty hunter" in that it enables an agency to replenish its funding through recovery audits and recovery activities. The Act states that funds collected but not used to pay the expenses of the agency's recovery audit program "shall be credited to the appropriations from which the erroneous payments were made, shall be merged with other amounts in those appropriations; and shall be available for the purposes and period for which such appropriations are available." Like the private

contractor/auditor, the agency also will have the incentive to aggressively assert and collect the largest amount of "overpayments" it can determine. The integrity of each of these audits will be open to question.

II. FAR Changes Impose Duty on Contractors

Standing alone, the FY '02 DOD Act's provision for the recovery audit of "overpayments" would be enough to occupy contractors' attention for months to come. Yet, further developments will exacerbate the "overpayments" issue for contractors. Federal Acquisition Circular ("FAC") 2001-02, published on Dec. 18, 2001, is an example. 66 Fed. Reg. 65353 (Dec. 18, 2001). FAC 2001-02 added language to FAR 52.232-25 ("Prompt Payment"), 52.232-26 ("Prompt Payment for fixed-price architect-engineer contracts"), and 52.232-27 ("Prompt payment for construction contracts") that states:

Overpayments. If the Contractor becomes aware of a duplicate payment or that the Government has otherwise overpaid on an invoice payment, the Contractor shall immediately notify the Contracting Officer and request instructions for disposition of the overpayment.

Comments accompanying FAC 2001-02 discussed the reasons underlying the new contract language, stating:

Implemented a General Accounting Office (GAO) recommendation. In July 1999, the GAO published a report (GAO/NSIAD-99-131) entitled "Greater Attention Needed to Identify and Recover Overpayments." After examining the process for identifying and collecting overpayments, GAO concluded in their report that "Under current law, there is no requirement for contractors who have been overpaid to notify the Government of overpayments or to return overpayments prior to the Government issuing a demand letter" (*i.e.*, formal notification to the contractor to pay money owed to the Government). One of the recommendations of the report was that DOD require contractors to promptly notify the Government of overpayments made to them. Accordingly, the FAR rule adds a paragraph to the prompt payment clauses that requires the contractor to notify the contracting officer if the contractor becomes aware of an overpayment. 66 Fed. Reg. 65354.

Thus, the new prompt payment clause language imposes an additional duty on contractors to notify the contracting officer "immediately" of an "overpayment" and to request instructions on disposition of the "overpayment." The regulation contemplates that this additional contractor duty precede the procedures established in FAR 32.6. In addition, the contractor must perform this duty "if the contractor becomes aware" of an overpayment. For reasons that follow, the new contract language is fraught with potential problems.

First, "overpayment" is undefined. The new contract language speaks in terms of a "duplicate payment" or an instance in which the government has "otherwise overpaid"

the contractor. This could cover virtually any type of government claim. Typical government claims for overpayments include not only duplicative payments and failures to provide discounts, but also defective pricing claims and government claims for Cost Accounting Standards noncompliance. The promulgation comments indicate that the contractor is, to some undefined extent, responsible for spotting and acting upon government claims before *the government* might even become aware of the potential claim. The comments make clear that the intent of the prompt payment clause is to compel the contractor to act in advance of a contracting officer's demand letter. Stated otherwise, the new contract language is a shortcut to avoid the requirements of FAR 32.6.

Contractors may take little comfort in the new contractual language requiring the contractor to act "immediately" "if the contractor becomes aware" of an overpayment. Most contractors already have systems in place to match receipts with billings and to detect differences between the two. To the extent that such systems exist, the government may argue that the contractor now has the affirmative duty to search for overpayments of all types. If a contractor were to argue it need not search for potential government claims in a systemic manner, the government (or other third party, such as a *qui tam* relator) could respond that the contractor is acting in deliberate ignorance or reckless disregard of the falsity of its invoices. *See* 31 U.S.C. §3729 *et seq.*

Moreover, the contractor must perform this new duty "immediately"--whatever that means. Presumably, it means faster than "within a reasonable time." Otherwise, the new contract language would have stated that the contractor must act "within a reasonable time." The ramifications of this requirement are worrisome.

III. New DCAA Audit Guidance Overreaches

Adding to the complexity of the area of overpayments is DCAA audit guidance dated Nov. 2, 2001, entitled "Audit Guidance on Special Purpose Audits of Contract Overpayments and Progress Payments." DCAA grounded the need for audit guidance on GAO reports and the then-proposed additional prompt payment clause language later effected by FAC 2001-02. DCAA discussed its previous revisions to one of the DCAA Standard Audit Programs ("SAP") to:

Ensure contractors have adequate written policies and procedures for comparing amounts billed to amounts received for contract payment and appropriately notifying the paying office if the amounts differ. If overpayments are received, the contractor should return the overpayment to the paying office.

Review contractors' comparisons to ensure the written policies and procedures have been effectively implemented.

DCAA's audit guidance makes clear that the requirements of FAR 32.6 are of little concern in the area of "overpayments." DCAA states:

Subsequent to the revision of [DCAA Standard Audit Program], the GAO conducted an evaluation of contract overpayments titled

"Excess payments And Overpayments Continue To Be A Problem" (GAO Report No. GAO-01-309, dated February 22, 2001). We assisted the GAO during the evaluation by obtaining and verifying contract information from selected contractors with significant contract payments and contract refunds in FY 1999. Based on our participation in the evaluation, we identified the need to enhance our audit coverage in this area. For example, several contractors did not identify and repay (refund) amounts due the government in a timely manner. Additionally, we found that some contractors' policies and procedures on the use of offsets were inconsistent and subjective. One contractor did not notify the government or refund a significant contract overpayment because the contractor believed that the contract was in an overall underpaid status, *i.e.*, the contractor had not been fully reimbursed for the total dollar value of progress payments and invoices previously submitted on the contract. *This is not a valid reason for not notifying the government and refunding overpayments. The contractor should notify the government of all significant overpayments, regardless if the contract is in a net over or under paid status.* [Emphasis added.]

DCAA's additional audit guidance states that "overpayments can occur because of payment mistakes (*e.g.*, duplicate payments) or because of contract administration adjustments." There will be an audit program to test a contractor's billing system internal controls "with particular emphasis on ensuring overpayments are promptly refunded or appropriately offset against billings." In addition, contractors should have written internal control policies and procedures that:

- (1) require a listing of all significant offsets;
- (2) require that significant offsets of government paying office errors and contract administration adjustments are made based on notification to and written instructions from the contracting officer and/or paying office;
- (3) require review of subcontractors' accounting and billing systems for the identification and timely resolution of subcontract overpayments, refunds and offsets; and
- (4) require timely response to demand letters issued by contracting officers and paying offices.

The new audit guidance states that auditors should notify the paying office immediately "if a significant contractor overpayment is disclosed during the audit and the contractor has not notified the government; or the overpayment is over 30 days old; or the offset was not done in accordance with written instructions from the contracting officer and/or paying office." Finally, according to DCAA, contract administration adjustments account for 77 percent of all refunds, and "[t]hese adjustments occur when contract payments are received in accordance with contract provisions but need to be reduced due to subsequent events or actions." DCAA clearly includes progress payments within the

audit for overpayments, focusing on loss positions, alternate liquidation rates, and changes in quantity or schedules.

The new DCAA audit guidance is problematic for both legal and practical reasons. From a legal perspective, DCAA is incorrect in objecting to a contractor's practice of considering an overpayment on a single payment request in the context of the entire record of contract payments. "Overpayment" only makes sense with reference to the total work performed by the contractor and the amount of money owed by the government under the contract. If the government fails to honor one payment request but pays twice on the *next* payment request, there simply is no "overpayment." In this example, the contractor has merely received the amount to which it is entitled. Moreover, as discussed above, FAR 32.606(b) requires the contracting officer to consider contractor claims against the government to fairly determine the net amount due the government.

The DCAA audit guidance also is problematic in extending the concept of "overpayment" to contract administration adjustments. The audit guidance states that "[t]hese adjustments occur *when contract payments are received in accordance with contract provisions but need to be reduced due to subsequent events or actions.*" (Emphasis added.) In this statement, DCAA admits that the payment received by the contractor accords with contract requirements but contends reductions must be made due to "subsequent events or actions." Far from auditing for overpayments, this would constitute second-guessing. To the extent that DCAA focuses on progress payment administration, DCAA intrudes into an area explicitly given to the Administrative Contracting Officer ("ACO") to administer pursuant to FAR 32.5.

DCAA's audit guidance further requires that the contractor review subcontractor accounting and billing systems for "identification and timely resolution of subcontract overpayments." DCAA's position that prime contractors must perform this function is at best questionable. The government has no privity of contract with subcontractors; accordingly, the government's ability to inquire into subcontractor billing systems and potential overpayments by the prime contractor to the subcontractor is debatable. Subcontractor performance has always been the prime contractor's responsibility, and (other than a few mandatory flowdown clauses) the manner in which the prime contractor chooses to perform that responsibility is for the prime contractor to negotiate with the subcontractor.

Practically, the DCAA audit guidance appears to be a case of the "audit tail wagging the procurement dog." With its emphasis on written notification to and instructions from the contracting officer regarding each instance of "overpayment," review of subcontractor accounting and billing systems, and contract administration adjustments made subsequent to payments that accorded with contract requirements, the DCAA position would increase the administrative burden in terms of delay and paperwork for both contractors and their government counterparts.

IV. Potential Impact on Contractors

Contractors are likely to see the effects of §831, FAC 2001-02, and the DCAA audit guidance in at least three areas: progress payments, provisional billing rates, and limitation on payments clauses.

As discussed above, DCAA's audit guidance views progress payments as a fertile hunting ground for "overpayments." DCAA intends to second-guess ACO administration of progress payments at least with respect to a contractor's loss position, alternate liquidation rates, and the effects of quantity or schedule changes. Although FAR 32.5 gives the responsibility to administer progress payments to the ACO, DCAA's audit guidance signals its intention to become more heavily involved in this area. Practically, the audit guidance will restrict the ACO's exercise of discretion.

With respect to provisional billing rates, contractors may find themselves under a new duty to adjust those rates with reference to actual rates during the course of contract performance in a fiscal year. Under FAR 42.704, the parties may agree on indirect rates for billing purposes. That regulation states in part:

(b) The contracting officer... or auditor shall establish billing rates on the basis of information resulting from recent review, previous rate audits or experience, or similar reliable data or experience of other contracting activities. In establishing billing rates, the contracting officer ... or auditor should ensure that the billing rates are as close as possible to the final indirect cost rates anticipated for the contractor's fiscal period, as adjusted for any unallowable costs. When the contracting officer ... or auditor determines that the dollar value of contracts requiring use of billing rates does not warrant submission of a detailed billing rate proposal, the billing rates may be established by making appropriate adjustments from the prior year's indirect cost experience to eliminate unallowable and nonrecurring costs and to reflect new or changed conditions.

(c) Once established, billing rates may be prospectively or retroactively revised by mutual agreement of the contracting officer ... or auditor and the contractor at either party's request, to prevent substantial overpayment or underpayment. When agreement cannot be reached, the billing rates may be unilaterally determined by the contracting officer ...

The new requirement for a contractor to return "overpayments" of which it "becomes aware" may be interpreted to require contractors to track actual rates against provisional billing rates and make a refund to the government whenever the billing rates exceed the actual rates during its fiscal year. The rationale would be that since the contractor is aware of its billing rates and its actual rates, the contractor must also be "aware" when the former exceed the latter resulting in an "overpayment." The prompt payment clause now requires that the contractor request disposition instructions from the contracting officer. In this manner the new "overpayments" requirements could obviate the usefulness of FAR 42.704.

A third example of the potential effect of the new "overpayments" requirements is in the area of limitation on payments clauses. Several contract clauses, such as the Incentive Price Revision clause, FAR 52.216-16, contain quarterly limitation on payments statement requirements. FAR 52.216-16(g) requires the contractor, on a quarterly basis, to submit a statement to the ACO essentially showing a comparison of (1) the total costs allocable to supplies delivered and accepted by the government and (2) the portion of target profit that is proportionate to supplies delivered and accepted by the government with (3) total amount of all invoices or vouchers for supplies delivered and accepted by the government. To the extent that the sum of (1) and (2) exceeds (3), the contractor must refund the difference as an overpayment.

As with provisional billing rates, the new "overpayments" requirement could force a contractor to perform the limitation on payments statement exercise more frequently than quarterly. Because the contractor has the cost and payment information available on a continuous basis, the contractor arguably is "aware" of an overpayment at least as frequently as every billing and payment cycle. Again, under DCAA's interpretation--and contrary to FAR 32.606(b)--the determination of an "overpayment" would be made without regard to any underpayments by the government, and the contractor would have the duty to "immediately" notify the contracting officer to request disposition instructions on this potential government claim.

Beyond questions regarding how the new "overpayments" requirements will work with existing contract requirements and procedures, an even more troubling prospect is the potential relevance of "overpayments" to issues of past performance, compliance, and contractor integrity. Notwithstanding the difficulty of the broad language of the new prompt payment clauses and the narrow (and legally suspect) DCAA interpretations, a contractor's failure to comply with the new "overpayments" requirement could reflect adversely on its integrity. The contractor could be accused of retaining monies to which it was not entitled. As a contract requirement, failure to abide by the "overpayments" requirement could implicate past performance issues and compliance issues as well.

V. Conclusion

Contractors will soon have to contend with new legislation, new regulations, and new audit guidance on overpayments that, coincidentally, mirror the heightened audit oversight that characterizes the post-Enron world. Absent a change in the direction of these developments, contractors will find themselves doing the government's work at their own expense. Accordingly, contractors should closely monitor the forthcoming OMB guidance, and actively participate in the rulemaking process in order to make recovery audits at least manageable. With respect to the new language in the prompt payment clauses, contractors should emphasize to contracting officers that "overpayments" are limited to instances such as inadvertent double payments by the government. Finally, contractors should firmly oppose DCAA's efforts to expand "overpayments" to include government claims and to evade the requirements of FAR 32.6.

¹ - Section 831 also appears biased in favor of government audit functions for performance of the audit work. The Act requires: "Before entering into a contract with a private sector source for the performance of services under a program of the executive agency carried out under section 3561 of this title, the head of an executive agency shall comply with (1) any otherwise applicable provisions of OMB Circular A-76; and (2) any other applicable provision of law or regulation with respect to the selection between employees of the United States and private sector sources for the performance of services." Thus, the performance of the recovery audit function will likely fall to the same audit agencies within the government that already conduct audits on contractors, resulting in further unnecessary audits.

New Fraud Detection Measures for Auditors: The Impact on Government Contractors

**by
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I. Introduction

The current crisis in the auditing community was not due solely to the Enron and Worldcom scandals. Although episodes of massive audit failures are relatively rare compared with the number of all financial statement audits, there have recently been several other well-publicized cases of problem audits, such as Arizona Baptist and Global Crossing. As a consequence, the public has lost confidence in audit opinions that accompany financial statements, and Congress is presently considering corrective legislation.

Since 1997, the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA) has maintained a focus on fraud in financial accounting. Recently, the AICPA issued a proposed Statement of Auditing Standards, *Consideration of Fraud in a Financial Statement Audit*, which would replace Statement of Auditing Standard (SAS) No. 82.¹ On May 15 (before the comment period on the proposed Standard had even expired), the AICPA proposed to amend its current guidance concerning management representations about fraud found in Statement of Auditing Standard (SAS) No. 85.² These changes would affect all SEC registrants, including, of course, government contractors. Given the current oversight of government contractors' costs, it is important to consider the impact that these changes to financial auditing will have on contractors.

As a generally accepted auditing standard, the proposed SAS would apply to government contractors. The purpose of this article, however, is not to examine the merits of the proposed changes. Rather, this article examines and comments upon the likely impact these changes will have on the government contracting community. Given the multitude of integrity-based accounting practices with which government contractors must comply, many may perceive the new SAS as yet another component of an already complex system. Indeed, the new SAS may mark the beginning of an era where *commercial* parties are held to a standard of fraud scrutiny heretofore limited to government contractors.

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II. Background

A government audit and an audit of financial statements are fundamentally different. Generally, a government audit is in the nature of a compliance audit; it seeks to determine the extent a contractor complied with applicable government cost accounting requirements. The typical government audit report is sent only to a contracting officer. On the other hand, the audit of financial statements is done to assure individuals outside the company (investors, creditors, regulators) that there are no material misstatements. To an extent, the work of government auditors and CPAs³ could overlap in that they may review the same financial information, albeit for a different purpose. In this regard, a government audit might entail a review of financial capability, which would require a review of financial records.⁴

III. The Auditing Standards Board Proposal

A. The Feb. 28 Proposal

The financial statements consist of the balance sheet, the income statement, and the statement of cash flows. Although the Exposure Drafts of the AICPA's Accounting Standards Board supersede SAS No. 82 and amend SAS No. 1, they do not alter any currently applicable requirements related to the audits of financial statements. Auditors must still plan and perform their audits in order to attain a reasonable assurance that the financial statements, which are prepared by management, do not contain material misstatements.

SAS No. 82 set forth fraud risks that auditors are to consider in their work. However, auditors were not considered to be investigators, and therefore are not expected to root out all forms of financial chicanery. The AICPA proposal does not fundamentally change this role. In response to the growing problem, the Exposure Draft of the Accounting Standards Board (ASB) states⁵:

This important initiative of the ASB and its Fraud Task Force is part of a broader AICPA program to address the growing concerns about fraudulent financial reporting. Although the proposed Statement resulting from this initiative addresses the auditor's effectiveness in detecting material misstatements in financial statements due to fraud, broader efforts are needed focusing not only on the auditor's role, but that of management, the audit committee, regulators, and others addressing this important issue, and focusing not only on the *detection* of fraud, but on *prevention* and *deterrence* as well. [Emphasis in the original.]

The Exposure Draft significantly enlarges the information auditors must consider when addressing fraud risks. As proposed, the new rules *mandate that CPAs inquire about* the following:

18. The auditor should inquire of management about:

- Whether management has knowledge of any fraud that has been perpetrated or any alleged or suspected fraud;
- Whether management is aware of allegations of fraud, for example, because of communications from employees, former employees, analysts, short sellers, or other investors;
- Management's understanding about the risks of fraud in the entity, including any specific fraud risks the entity has identified or account balances or classes of transactions for which a risk of fraud may be likely to exist;
- Programs and controls the entity has established to mitigate specific fraud risks the entity has identified, or that otherwise help to prevent, deter, and detect fraud, and how management monitors those programs and controls;
- For an entity with multiple locations, (a) the nature and extent of monitoring of operating locations or business segments, and (b) whether there are particular operating locations or business segments for which a risk of fraud may be more likely to exist;
- Whether and how management communicates to employees its views on business practices and ethical behavior.

19. The inquiries of management also should include whether management has reported to the audit committee or others with equivalent authority and responsibility on the entity's internal controls, and how management believes the internal controls (including the entity's control environment, risk assessment processes, control activities, information and communication systems, and monitoring activities) serves to prevent, deter, or detect material misstatements due to fraud. [Footnotes omitted.]

Thus, the audit team will be specifically required to discuss the likelihood of fraud during audit planning, how fraud might be accomplished, and what measures should be taken to detect its existence. In addition, the auditor must still evaluate a company's internal controls, but must now consider the adequacy of those controls with respect to the risk of fraud. Under the proposal, the focus is not so much on possible episodes of fraud, as on the likelihood of material financial misstatements due to fraud.⁶ The ASB explained its rationale for placing the emphasis on inquiries of management as follows⁷:

Management has a unique ability to perpetrate fraud because it frequently is in a position to directly or indirectly manipulate accounting records and present fraudulent financial information.

Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.

The proposed guidance adds new procedures regarding the reporting of fraud to management, the audit committee of the board of directors, as well as successor auditors or others.

B. The May 15 Proposal

On May 15, 2002, the AICPA issued proposed amendments to SAS No. 85, *Management Representations*. The amendments are consistent with the Feb. 28 Exposure Draft. Specifically, the AICPA proposal would change the current guidance in SAS No. 85 concerning management's representations about the likelihood of fraud with respect to inquiries to management as follows:

h. Management's acknowledgment of its responsibility for the design and implementation of programs and controls to prevent and detect fraud.

i. Information concerning fraud ***that has been perpetrated on the entity and any alleged or suspected fraud*** involving (1) management, (2) employees who have significant roles in the financial reporting process, or (3) others where the fraud could have a material effect on the financial statements.

j. Information concerning any allegations of fraudulent financial reporting on the part of the entity received in communications from employees, former employees, short sellers, financial analysts, or others.

Appendix A proposed some sample management representation letters that primarily inserted language such as "we have no knowledge of" at appropriate points. The guidance would apply to audits begun on or after Dec. 15, 2002. The essential purpose of the guidance is to change management's representations to the auditor concerning fraud. By declaring in writing to the audit firm that "we have no knowledge of" any alleged or even suspected fraud, management would be making itself liable under circumstances where it either knew or should have known that fraud existed.

IV. Government Standards

Government auditors, of course, do not audit the financial statements of government contractors, so the Statements of Auditing Standards are inapplicable to their work. As stated above, government audits are not financial audits, but are in the nature of compliance audits. Specifically, government audits seek to determine a contractor's compliance with government cost accounting requirements, i.e., identification and

exclusion of unallowable costs, adherence with cost limitations, audit trails for contract costs, and so on.

As in the commercial world, the government takes the position that its auditors are not investigators. This policy statement is found in §4-702.2b of the DCAA Contract Audit Manual (CAM)⁸:

Auditor Responsibilities for Detecting and Reporting Fraud

b. Auditors are not trained to conduct investigations of illegal acts. This is the responsibility of investigators or law enforcement authorities. Auditors are responsible for being aware of fraud indicators, vulnerabilities, and potentially illegal expenditures and acts associated with an audit area (see 4-702.3a. and b.). When an auditor obtains information that raises a reasonable suspicion of fraud or other unlawful activity that has not been previously disclosed to the government, an investigative referral should be initiated (see 4-702.4).

With respect to the auditor's responsibility to detect fraud, the CAM urges the auditor to be alert to the presence of fraud. In this regard, §4-702.2a states the following in pertinent part:

This alertness, combined with a contractor's internal controls and the auditor's normally programmed tests of procedures and transactions, should provide a reasonable degree of assurance for disclosing fraud or other unlawful activity. (See also 4-702.3.)

While the CAM specifically advises that auditors are not investigators⁹, auditors nevertheless are directed to take a somewhat active role in detecting fraud. Indeed, there are a number of parallels between the existing CAM and the proposed revisions to SAS No. 82 that will require more affirmative action on the part of auditors. Consider, for example, the subject of making inquiries of management quoted above from the Exposure Draft. While the CAM has no such requirement, the CAM does have similar expectations that its auditors will be alert to fraud indicators.

The CAM provides, throughout Part 4, that auditors should utilize leads from external sources in the detection of fraud or other unlawful activity¹⁰ (allegations from company employees, disgruntled participants, phone calls or letters). Similarly, government auditors are expected to "design audit steps and procedures to provide reasonable assurance of detecting errors, irregularities, abuse, or illegal acts that could have a direct (or indirect) and material affect of contractor financial representations or the results of financial-related audits."¹¹ Finally, like the Exposure Draft, the CAM already expects the auditor to ensure that a contractor has communicated its ethical standards to its employees as well as its subcontractors¹².

V. Comments

It would appear that the commercial arena is establishing fraud standards for CPAs that exceed the fraud standards used by government auditors, because the proposed revisions put the burden on the auditor to make *affirmative inquiries* of management regarding potential indicators of fraud. Additionally, the audit team must discuss the likelihood of fraud, and how it might occur. As discussed above, however, these standards compliment the current guidance in the CAM. It would appear that commercial entities will experience a level of fraud scrutiny to which government contractors have long been held. The question is whether this additional scrutiny will have any impact on government contractors.

From the auditing perspective, it is unclear to what extent government auditors might rely on the fraud detection work of CPAs. As noted above, government auditors may be called upon to perform financial responsibility audits. This entails a review of financial statements, annual reports, and other information. Clearly, any conclusions arising from the requirement to engage in affirmative inquiries about fraud will be of interest to the government auditors. The responses to such inquiries could have an impact on determinations of contractor responsibility. Whether the government auditor would have made an independent determination would depend on the tenacity of the individual auditor, but the CAM suggests such efforts be undertaken. The proposed revisions to the SAS might just enhance those efforts.

Because the proposed SAS would require an auditor to inquire whether management has knowledge of any fraud (even alleged or suspected fraud), management must make a material representation in response. If the response is "knowingly and willfully" false, it may constitute a false statement under the False Statements Act.¹³ The statement need not be made to the government to be actionable; it need only involve a government agency's activity, e.g., the SEC. Thus, commercial entities might face an area of civil and criminal exposure to which government contractors are already vulnerable. As for government contractors, they should already have systems in place to address the veracity of their statements. This is due to the government contracting environment, the need to comply with elevated recordkeeping and reporting requirements and legislation such as the False Statements Act.

A. Voluntary Disclosure

In responding to an auditor under the proposed SAS, there is an area of risk somewhat unique to government contractors: the voluntary disclosure program. The voluntary disclosure program focuses on disclosure of procurement fraud, so inquiries into the financial statements may not necessarily implicate that subject.

Nevertheless, the potential exists that a disclosure to an auditor conducting a financial audit could relate directly to a matter of procurement fraud. The question then arises whether such a disclosure would be consistent with the terms of a disclosure agreement between the government and the contractor. A disclosure independent of the voluntary disclosure program, particularly one that leads to an investigation, may not afford a contractor the protection of the disclosure program.

B. Government Auditors May Request Work Papers

Another unique consideration for the government contract community involves the prospect of CPA work papers being requested by government auditors. Government auditors' interest in CPA work papers is nothing new. That those work papers may contain information about the auditor's affirmative inquiries into risks of fraud will obviously make them more enticing to government auditors.

The general authority for access to records is found in the Audit and Records clauses of the Federal Acquisition Regulation (FAR). These provisions are fairly specific in their purpose: to examine that costs claimed have been incurred; to evaluate the accuracy, completeness, and currency of cost or pricing data; and to examine "directly pertinent records involving transactions related to "a contract".¹⁴ The work papers of a financial auditor that relate specifically to a government contract will continue to be of interest to government auditors. Moreover, the Boards and Courts have been somewhat permissive in the area of access to records. In the seminal case of *SCM Corp. v. United States*, 645 F.2d 893 (Ct. Cl. 1981), for example, the Court, in interpreting the then "Audit-Negotiation" clause, held that government auditors were entitled to copy and remove company "proprietary" information. Whether the work papers of the CPA would be considered proprietary is another question. That, however, presents an entire body of law that is beyond the scope of this article.

Finally, government contractors will recognize the similarity between the affirmative inquiries regarding fraud under the proposed SAS and the requirement for a certification of cost or pricing data under the Truth in Negotiations Act (TINA).¹⁵ When required under the statute and regulations, a contractor must certify that cost or pricing data are current, accurate, and complete to the best of the contractor's knowledge and belief. This is similar to the "we have no knowledge of" requirement in the proposed changes to SAS No. 85. If the TINA certification is not true, i.e., the cost or pricing data are not current, accurate or complete as of the date identified in the certification, then the contractor will be subject to penalties for any increase in price to the government arising therefrom. While TINA is independent of traditional concepts of fraud, it presents a circumstance quite similar to the proposed SAS: the requirement for affirmative statements about the accuracy of data. Moreover, it is yet another example of how government contractors have long been required to have mechanisms in place to assure the accuracy of their affirmative certifications.

VI. Conclusion

The current turbulence in the accounting profession will have a ripple effect on government contract audits, the parameters of which have not yet been addressed by government regulators. However, government contractors historically have been subject to a great deal of scrutiny in cost accounting, as well as procurement integrity; hence, they should have systems in place that accommodate these changes. In contrast, commercial entities, which lack such controls, will find themselves far more vulnerable

to episodes of fraud and liability. At the very least, these changes will affect the relationships among CPAs, management, and government auditors.

Endnotes

- ¹ - Exposure Draft, *Proposed Statement of Auditing Standards: Consideration of Fraud in a Financial Statement Audit*, AICPA Auditing Standards Board, Feb. 28, 2002.
- ² - Exposure Draft, *Proposed Statement on Auditing Standards and proposed Statement on Standards for Attestation Engagements Omnibus 2002*, AICPA Auditing Standards Board, May 15, 2002.
- ³ - Those who express an audit opinion on financial statements must by law be CPAs, but there is no requirement for government auditors to be CPAs. For terminology purposes only, we refer in this article to those who perform financial statement audits as "CPAs," and we use the general term "government auditor" to refer to those doing government audits. We recognize that this terminology is not accurate as some government auditors are CPAs.
- ⁴ - Admittedly, the differences between government audits and commercial audits are somewhat technical. The practical distinction, however, may not be so great. An adverse government audit could have the same impact as a CPA's adverse audit opinion. A government audit may lead to claims of violation of a number of statutes, from the Truth in Negotiations Act (TINA) to the False Claims Act, and could result in litigation or suspension/debarment. As we have seen, financial audits could lead to scandals such as those mentioned above.
- ⁵ - Exposure Draft, *Proposed Statement of Auditing Standards: Consideration of Fraud in a Financial Statement Audit*, AICPA Auditing Standards Board, page 23, Feb. 28, 2002.
- ⁶ - Carol Kirwan, "Consideration of Fraud in a Financial Statement Audit," Maryland Association of C.P.A.s, *The Statement*, p. 23, May/June 2002.
- ⁷ - Exposure Draft, *Proposed Statement of Auditing Standards: Consideration of Fraud in a Financial Statement Audit*, AICPA Auditing Standards Board, page 20, Feb. 28, 2002.
- ⁸ - DCAA Contract Audit Manual, Section 4.702, January 2002.
- ⁹ - CAM §§4-702.2b., 4-702.5a., 4-702.6.
- ¹⁰ - CAM §4-702.1a., 4-702.3c.
- ¹¹ - CAM §4-702.2. See also CAM §4-706.3.
- ¹² - CAM §4-704.3.
- ¹³ - 18 U.S.C. §1001
- ¹⁴ - FAR 52.214-26; FAR 52.215-2.
- ¹⁵ - 10 U.S.C. §2306a; 41 U.S.C. §254(d).

**AN ASSESSMENT
OF TODAY'S FEDERAL PROCUREMENT SYSTEM**

**REMARKS OF STEPHEN M. DANIELS
CHAIRMAN,
GENERAL SERVICES BOARD OF CONTRACT APPEALS**

**OFFICE OF FEDERAL PROCUREMENT POLICY LECTURE SERIES
AUGUST 15, 2002**

The 1990's were a great time in America, and especially a great time for business in America. Or were they? With each passing week, there seem to be more revelations that cause us to question whether the truths that were generally perceived back then are as real as we once believed.

Remember how stock prices would go up and up and up on an almost daily basis? And why not? After all, we were told, shares of dot-coms were worth vast multiples of earnings (or even of anticipated future earnings, for those companies that were not making any money). And all sorts of very big companies were making tremendous profits – or so they said. Private businesses were supposed to be engines driving an economic boom that would make all Americans rich and build bonds that would unify peoples throughout the entire world.

Yes, business was great – and business practices were even better. Business practices were so good that if we wanted to make Government work well, we needed to remake Government processes in the image of business.

We're all a little older and wiser now. We know that the stocks of dot-com companies were enormously overvalued – if those stocks ever had any value at all. The prices of stocks of many other companies were inflated, too – based on some pretty gross accounting tricks and other forms of dishonest behavior. Multinational companies may eventually be a helpful force in bringing about a prosperous, cooperative world – but there seems to be more than a bit of divisiveness on our planet right now. Maybe – well, more than maybe – we have learned that some of those business practices at whose shrine many in Government worshiped are not quite all they were cracked up to be.

Some of those good business practices that we were told to follow were business procurement practices. We were supposed to remake, or "reinvent," or "reform," Government procurement along different lines – what was said to be the business way of doing things. And we did. Government procurement is conducted today in ways which are considerably different from the ways in which it was conducted only a decade ago.

But are the current ways really better than the old ones? Or, to ask the question in a bit more sophisticated manner, in making significant changes, have we abandoned too much of the old? Are the ways in which the Government acquires goods and services

today genuinely superior, as their proponents told us they would be – or do they deviate so far from fundamental principles of Government procurement, and incorporate so much of the Enron/WorldCom/whatever-company-is-in-the-news-this-week style of business practices, that they are actually counter-productive?

These are important questions for those of us in the Government procurement world – and for all American taxpayers. I don't mean to sound like the Cassandra of Government procurement, but I did raise similar questions during the past decade, as the "reinventions," or "reforms," were taking hold. Only a few brave souls were willing to acknowledge that they were even listening back then. I'm very much encouraged to see that our Government now has an Administrator for Federal Procurement Policy who is interested in hearing what people have to say about the answers to these questions, in promoting an open and honest discussion on the subject, and in leading the effort to bring balance to our procurement system by combining the best of the new and the old. Understanding that this effort is under way, I was willing to accept her invitation to come here today to share my views with all of you.

I want to acknowledge at the outset my background and my biases. I was a staff member of the House of Representatives' Government Operations Committee – now called the Committee on Government Reform – for nearly 15 years. That committee, then and now, has been responsible for originating legislation which sets the Government's fundamental procurement policies. I worked for a committee leader who had been a member of the Commission on Government Procurement in the early 1970's, and who worked cooperatively with other members of the House and Senate, on both sides of the aisle, to make the procurement system follow the principles enunciated by that Commission. Those principles found a home most notably in the Competition in Contracting Act of 1984, or CICA. I will discuss them in a minute, but for now, I will confess that I continue to believe that they are critical guidance for a successful Government procurement system.

I left the Government Operations Committee in 1987, when I was named a judge on the General Services Board of Contract Appeals, and I have remained a judge on that board ever since. For my first nine years as a judge, the board heard and decided protests involving the procurement by Federal agencies of what is now called information technology resources. This work involved interpreting and applying the Competition in Contracting Act and the regulations which implemented it. Hearing protests reinforced my belief in the validity of the principles of the Act, including the merit of enforcing those principles, as critical to the successful operation of the Federal procurement system.

For the past six years, since the Board's protest authority has been revoked, I have focused my activities on hearing and resolving disputes which arise in relation to Government contracts which have already been awarded. While this work teaches me a good deal about how not to administer contracts, it doesn't give me the ringside seat I once had on how agencies choose the companies with which they do business. But I do follow these activities from a distance, and I do think about how they relate to the

principles that guided Government procurement until the past decade. It is these thoughts that I would like to share with you today.

I also want to make clear that everything I tell you represents my own opinions. I am not here representing the General Services Board of Contract Appeals, the General Services Administration, the United States Government, or anyone else. One of the privileges and responsibilities of being a judge is to be independent – to give your own honest views on subjects you address, regardless of the political fallout. That is what I am here to do.

Let's begin with the principles of the Competition in Contracting Act of 1984. I want to emphasize that these were hardly new principles at the time. They had been evolving since the early years of the Republic and had come to represent common wisdom. There are, I think we can distill, four guiding principles:

First, the opportunity to sell goods and services to Government agencies must be open to everyone. The system must be democratic; it cannot presume that simply because a capable vendor is unfamiliar to an agency, the agency can't benefit from doing business with him or her.

Second, vendors' offers must be evaluated fairly. The chance to bid cannot become a sham; equal opportunity must be an ingrained practice, not just a slogan.

Third, the agencies must select for contract award the offers that are in the best overall interest of the taxpayers. Genuine economy is the goal; there is no sense in being penny-wise and pound-foolish.

Fourth, the system must be transparent so that participants and taxpayers understand how it is being operated and can hold agencies accountable for their actions. The best way of maintaining the integrity of the system is to give vendors who believe they have been treated unfairly a full and fair chance to air their grievances. Impartial reviewers can then hold the agency personnel's feet to the fire to make sure they remember the importance of the first three principles.

As you will notice, these fundamental precepts of Government procurement are not necessarily business principles. They are principles of political philosophy designed with the interests of the taxpayers foremost in mind. Although the Government can learn from the private sector, in some respects it can never operate in the same manner as do business concerns. The success of a private company can be measured easily and objectively through profits and losses. An actual or prospective investor can readily perceive whether the company is being managed effectively; if it is not, the investor can sell stock or choose not to invest. Taxpayers, by contrast, cannot choose not to pay taxes. Even if they could, it would be very difficult for them to determine whether their money was being spent wisely. The missions of Federal agencies cannot be measured by profit and loss statements. Whether an agency is operating effectively is a highly subjective matter. Furthermore, purchasing activities are ordinarily secondary to the agency's

mission, with the result that evaluating the performance of procurement officials is extremely difficult if not impossible. Government officials owe a much higher degree of duty to the people for whom they perform – the taxpayers – than do their private sector counterparts to stockholders. They owe the duty of adherence to the basic political principles I have just identified – openness, fairness, true economy, and accountability.

And yet, though our traditional procurement system as exemplified by CICA was designed around political principles, rather than supposed business principles, that system, in design, represented the triumph of capitalism at its best. It channeled the creative, competitive impulses of private businessmen and women into developing more innovative solutions to Government problems and giving agencies the best possible prices for those solutions. Real competition in the Government marketplace should bring about the same kind of benefits for the Government that it provides throughout the general marketplace to each of us as consumers.

There were plenty of specifics in CICA that implemented the principles I just described. The law had as its watchword "full and open competition." It imposed tougher standards for justifying and approving exceptions to competition, so that sole-source contracting would be reserved for those instances in which it was truly necessary. Procurements had to be publicized, through notice in the Commerce Business Daily – now it would be FedBizOpps – so that potential suppliers would know of contracting opportunities. CICA was also another step forward in the effort to create a single, unified system of procurement. Reducing agency-specific peculiarities in the process strengthened competition, because it eliminated the handicap to companies that could offer good products at good prices, but weren't plugged into those unique ways of doing business. Finally, CICA strengthened bid protest procedures as an enforcement mechanism designed to ensure that the mandate for competition is implemented and that vendors wrongly excluded from competing for Government contracts receive equitable relief.

Although some parts of CICA remain on the statute books, the guts have been ripped out of it. Openness, fairness, economy, and accountability have been replaced as guiding principles by speed and ease of contracting. Where the interests of the taxpayers were once supreme, now the convenience of agency program managers is most important. Full and open competition has become a slogan, not a standard; agencies have to implement it only "in a manner that is consistent with the need to efficiently fulfill the Government's requirements." [10 U.S.C. §2304(j); 41 U.S.C. §253(h).]

It is now much easier to acquire goods and services without competition. Notice requirements have been reduced, particularly as the Government increasingly fulfills its needs without conducting formal procurements. The drive to have the Government present a single face to industry has been sent into retreat: agencies have been given greater discretion to procure in their own idiosyncratic ways, Government-wide regulations have been discarded or diminished in importance, and programs and whole agencies (the Federal Aviation Administration being just the first) are being allowed to procure under unique and sometimes vague rules and procedures. The bid protest forums

which tended to allow parties to develop facts most fully, and consequently to grant the greatest percentage of complaints – the General Services Board of Contract Appeals and the United States District Courts – have been stripped of their authority to hear protests.

What about these differences? Change can be either good or bad, and it usually has elements of both. The challenge for all of us in the Government contracting field, whether we're in Government or industry, is to manage that change so that the procurement system doesn't get out of kilter. Government succeeds or fails by the confidence of the governed in its fairness and effectiveness. So it is with the procurement system. If the public loses confidence in the system, it will fail. It will not deliver the goods and services that agencies need to perform their missions well, and what it does deliver will not necessarily be at reasonable prices. We procurement professionals need to make sure that at the same time we focus on efficiency and speed, we don't lose sight of the ultimate purpose of the system, which is to serve the taxpayer well.

When the Government contracts for goods and services, it has to spend money in three ways: conducting procurements, administering contracts, and paying for the goods and services themselves. The design for the way we contracted in the past emphasizes savings in the third group – the costs of paying for the goods and services. And this is as it should be. The Federal Government spends about \$240 billion a year through contracts, and this figure appears to be growing rapidly. Unless the laws of supply and demand were repealed when no one was looking, it should remain obvious that competition results in firms improving their products and/or reducing their prices to win contracts. Studies have indicated that looking to costs alone, competition can save the Government between 15 and 50 percent of what it ultimately pays for goods and services. Thus, competition can save several tens of billions of dollars – possibly more than a hundred billion dollars – on Federal procurement every single year. We're talking real money here, even by Federal budgeting standards.

The current approach to contracting emphasizes the first group of costs I identified – the costs of conducting procurements. I have never seen an estimate of how big this amount is, but I'll wager that it is just a tiny fraction of the \$240 billion a year that the Government spends on goods and services themselves. The current approach aims at saving part of this little sum. And it may well be succeeding. But whether it does or not won't matter much if it has a deleterious effect on the total price taxpayers pay for the goods and services.

Let's take a look at some of the ideas associated with the current approach. I'll discuss four groups of ideas – organizational structure, emphasis on past performance of vendors, methods of contracting, and the personnel who actually do the contracting. Then I'll close with a couple of thoughts about ramifications of the approach which are critical, but rarely mentioned.

I'll begin with organizational structure. An important theme of Government over the past decade was "empowering" personnel, bureaus, and agencies to acquire things using their own rules, regulations, and practices. As our Government has grown, a

which tended to allow parties to develop facts most fully, and consequently to grant the greatest percentage of complaints – the General Services Board of Contract Appeals and the United States District Courts – have been stripped of their authority to hear protests.

What about these differences? Change can be either good or bad, and it usually has elements of both. The challenge for all of us in the Government contracting field, whether we're in Government or industry, is to manage that change so that the procurement system doesn't get out of kilter. Government succeeds or fails by the confidence of the governed in its fairness and effectiveness. So it is with the procurement system. If the public loses confidence in the system, it will fail. It will not deliver the goods and services that agencies need to perform their missions well, and what it does deliver will not necessarily be at reasonable prices. We procurement professionals need to make sure that at the same time we focus on efficiency and speed, we don't lose sight of the ultimate purpose of the system, which is to serve the taxpayer well.

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constant hallmark of its operation has been disputes between central managers, who want things to run in accordance with standardized principles, and the folks in the agencies and bureaus, who want to be free to pursue their own interests in their own ways. For at least a half-century, in the procurement area, the centralizers were gaining. Under a unified set of regulations, variations in procurement practices among agencies and bureaus had been reduced to the point at which people in private industry knew to a pretty good degree what to expect when they set out to do business with the Government.

In the '90's, however, centrifugal forces gained the ascendancy. The Government became less of a unified whole, and more of a collection of quasi-corporate entities. As these entities do business each in its own way, the basic rules under which procurements take place, like the mechanisms for enforcing those rules, have been weakened.

These changes have created much greater uncertainty about the way in which procurements are conducted. Uncertainty, as anybody who has ever put together a bid or proposal knows, drives potential competitors out of the market and drives up the prices of those who stay in; if a bidder doesn't account for eventualities that might arise, and they occur, he can lose his shirt. Leaving major decisions to individual discretion in individual procurements can have devastating consequences for the prices the Government pays for what it buys.

The uncertainty is more than just momentary coping with change. As different agencies – and different procuring activities within those agencies, and probably even different program and contracting officers within those procuring activities – use different ways to acquire goods and services, potential suppliers face this problem: To the extent that the Government is like a single customer, each company has to spend a certain amount of money to get to know that customer's procedures and practices. If the Government becomes many customers, each firm is going to have to increase that kind of spending many times. Small companies have to restrict their learning budgets to a limited range of customers, so as the Government becomes fragmented, those companies won't have any real chance of satisfying the needs of as many agencies as they might have before.

Government officials who are encouraged to creatively reinvent procurement practices in unique ways have to realize that the more they do this, the more likely they are to cost the taxpayers money. We can save significantly by preserving a large pool of potential suppliers, cutting overhead costs for each one, and cutting overall prices naturally through competition. A unified approach is necessary to meeting these goals. There is no incompatibility, I should add, between uniform basic practices and creative means of implementing those practices with greater efficiency.

Another aspect of the current approach is to give greater importance to firms' past performance – or reputation – in choosing contractors. The Government has always paid attention to past performance, of course. For decades, it used responsibility determinations to keep from getting stuck with contractors who don't have the financial and other capabilities to perform in accordance with their promises. But there is now an

increased emphasis – often an over-emphasis – on past performance as an evaluation factor in negotiated procurements. Some contracting officers are writing solicitations that make reputation at least as important as technical merit or cost in evaluating proposals.

There are a number of difficulties with awarding contracts primarily on the basis of reputation. First, reputation is an inherently subjective measure, but the current procurement scheme requires that it be quantified so that it can be compared to other evaluation factors. By relying heavily on a quantification of an unquantifiable factor, every award decision is of suspect validity.

Even if quantification could be accomplished, while it would be quick and easy to award contracts primarily on the basis of reputation, it wouldn't be very smart. Agencies are buying promises of goods and services to be supplied in the future, not the past. Agencies that buy based on reputation would miss out, for example, on much of the innovation that has been going on in the computer industry, where new and small businesses have been the source of many of the terrific advances taking place in hardware, software, and creative resolution of problems. Government officials have to fight the temptation to overvalue reputation if they want to act, as they are supposed to act, as the taxpayers' proxy.

The need to apply reputational judgments judiciously has impacts far beyond individual procurements. We hear a lot these days about greater partnerships between Government and industry, and of course better communications have the potential for good on both sides. But we have to remember that there isn't a single "industry." Whether a firm is a part of the "industry" that participates in those informal communications has become critical to the company's ability to compete for and win contracts. Reputational judgments, like many forms of regulation, tend to exclude new entrants from the marketplace.

The use of past performance ratings has implications for restricting companies' legal rights and privileges, as well. The number of protests and contract claims has declined markedly over the past decade. Several lawyers and company officials have suggested to me that this is because "it's not cool" to object to Government actions any more. "It's not cool" is code for "I'm afraid that if I do it, my performance ratings will suffer, and I'll lose the chance for future contracts."

Handled the wrong way, past performance, with its impact on inclusion in the club of "industry partners," has become a hammer with which Government forces companies to give up rights, and ultimately money, for the opportunity to stay in the contracting game. And as valid protests are not filed, the taxpayers suffer – they are denied the benefits that come with informed oversight of the procurement system. Protests of course do have short-term costs in terms of delayed procurements and diverted activities of Federal employees involved in a procurement. But in exchange for these costs – a trade-off that the current approach doesn't take into consideration – protests keep participants in the system alert to wrongdoing, educate them to practices found by an unbiased observer to be fair or foul, thereby instill discipline in the way in

which agencies acquire things – and most important, preserve the true competition that brings down prices and improves the quality of product offerings. Similarly, if companies know in advance that they will be strongly dissuaded from litigating contract disputes, they may well increase their prices so as to remove some or all of the risk they face in not being able to recoup later incurred, but initially unexpected, costs they feel should be legitimately paid by the Government. The taxpayers may pay more in the long run than they would if the companies thought they could enforce their contract rights.

Let's move on now to a third aspect of the current procurement system, methods of contracting.

I'll begin with a couple of notes about competitive contracting – and I'll be brief here because this method of contracting, which used to be the paradigm, isn't used so much any more. A significant problem here is the use of contracting techniques which, like heavy emphasis on past performance, lead to highly subjective decisions for which accountability is limited or nonexistent. One is the increased use of oral solicitations, without any limitations, and, even for written solicitations, making contract awards on the basis of oral proposals. There may be no record of what transpired in what passed for a competition – and even if there is one, it will be so skimpy that proving a decision was sound or not will be very, very hard. Both sides may later regret that their contract rights and responsibilities were ill-defined, as well.

Agencies are also limiting, in the interest of efficient contracting, the numbers of firms allowed to compete in individual procurements. As this happens, some companies which submitted proposals that stood a reasonable chance of award will find themselves on the outside looking in. The message to them will be: "I'm sorry, your offer – you know, the one on which you've spent tens of thousands, or maybe even hundreds of thousands, of dollars – had a reasonable chance for award, but for reasons of administrative convenience, we decided that negotiating with you wouldn't have been worth the trouble. It wouldn't have been efficient." Whether those firms could have improved their proposals after discussions, and thereby given the taxpayers a better deal, will be immaterial. What sense does this make? We have to guard against designing a procurement system in which the secret to success is clever marketing or access to the "right" individuals. We don't need a system that favors slick over solid, lucky over smart, the well-connected insider over the ordinary citizen. The ability to limit competitive ranges must be used carefully.

These are problems with actual competitions, in which companies choose to participate after having notice that they exist. But they pale in comparison with the difficulties that result when the competitions are limited without any notice of their existence at all. More and more, this seems to be the preferred way for agencies to do business. It creates impediments and challenges to keeping the procurement system the servant of the taxpayer.

One of the favorite methods of acquiring goods and services without real competition is the use of umbrella task and delivery order contracts. Agencies issue

wide-ranging contracts to a number – often a very large number – of firms, and when they need something, they pick one of those firms to give it to them. These contracts are inherently biased against small business, because a small vendor who can provide the item to be ordered but not the wide range of items under the contract is excluded from any consideration. Even if that vendor could provide that item well and at a better price than could be had from one of the big companies that has a contract, it cannot get the business.

A further problem with umbrella contracts is that even among the big firms that do have the contracts, agencies have practically unfettered discretion in making awards of task or delivery orders. The prospect of abuse is readily apparent: agencies award contracts to most companies that want them, and choose later, for reasons of convenience rather than best value, which ones will get the orders. This process empowers procurement officials without giving them standards against which to make selections. The concept has some utility where differences are measurable, which is frequently true for goods, but where the differences are very difficult to gauge, which is often true for services, the use of umbrella contracts makes decisions about who gets contract money highly subjective. Because the laws about competition (and protests to enforce it) don't apply to the issuance of delivery and task orders, we may never know whether the use of umbrella contracts gives taxpayers beneficial results.

Another way agencies are acquiring goods and services without real competition is by placing orders against multiple award schedule contracts and their cousins, Government-wide acquisition contracts. These vehicles are basically agreements against which specified items may be ordered; the orders automatically incorporate the terms and conditions of the contracts.

CICA gave its blessing to the multiple award schedule program as a form of full and open competition. These contracts should be used, though, Congress explained, only when the Government can negotiate quantity-discount contracts, with delivery to be made directly to the using agencies in small quantities at diverse locations. These limitations are not being observed. Agencies are using schedule contracts to purchase items in large numbers, without any maximum ordering limitations. The dollar values of individual schedule buys are reaching the billion dollar range.

Agencies don't have to announce their use of this program in advance, as they once did. They can simply compare catalog prices or even ask a few pre-selected vendors to give prices, which may change on an order-by-order basis, and then choose a winner. This practice is nice and easy. It's not fair to all potential offerors, though; to have a shot at making a sale, a company must be a member of the "club" chosen in advance by the agency. And it's not fair to the taxpayers, either; they ought to be getting the best deals capable vendors can offer, not the results of secret competitions among a limited in-crowd of companies.

A year ago, the General Services Administration's Office of the Inspector General issued a report which concluded that GSA is not consistently negotiating most favored

customer prices for multiple award contracts; many multiple award contract extensions are accomplished without adequate price analysis; and preaward audits are not being used effectively to negotiate better schedule prices. Yet the use of the contracts continues unabated, to the tune of about \$15 billion a year. It's much easier than conducting competitive procurements – ergo, in today's world, it's better. But is it really economical, let alone fair? Proponents of buying off the schedules don't seem to care.

Agencies are also using undefinitized vehicles, like letter contracts, to buy things as large as construction of massive buildings. Instead of figuring out in advance what to build, and then taking bids to construct it, agencies are issuing letter contracts which say not much more than, in exchange for a price to be determined later, not to exceed X million dollars, a company agrees to build a building about so big to be used for such-and-such a purpose. There is no telling on what basis an agency might select a contractor to perform under this kind of contract. There is a high likelihood, though, that unless agencies are very generous to those contractors, the determination of how much to pay for work performed will be contentious.

Finally, the Government has handed out credit cards to untold numbers of employees for the purchase of – well, if you've opened a newspaper or watched a TV news show recently, you know that some of those employees have been purchasing all sorts of things that don't exactly meet Government requirements. In our haste to make buying easy, we haven't paid enough attention to controlling what is bought. And no matter how small the number of abuses of credit card privileges, or how few dollars have been involved, the media coverage of this form of ease of acquisition has brought public discredit on the entire Government procurement system.

On to the next aspect of today's procurement system: Who is going to be responsible for all these innovative procurements? The current approach has as one of its maxims that simpler procurements need fewer professionals to conduct. And consistent with this maxim, at the same time that greater discretion is being given to Government procurement personnel, the number of those folks has been reduced, in part by enticing the veterans who know how to get things done out the door through buyouts. What we need to be asking, but aren't, is, How big an investment in trained personnel does the Government need to do its job well? Significant personnel cuts force the contracting professionals who remain to do more work than they are capable of. Government officials are going to have to work hard to keep this trend from going too far.

An inevitable consequence of the personnel cuts, and the new demands on the time of the contracting officials who remain, is the temptation to cede more authority for procurements to the program offices for which the contracting personnel are doing the buying. This is a real problem. Program offices generally want whatever they need immediately, and as long as the contracting staff can bring it in within the budget for the acquisition, they don't particularly care how much it costs or how it was bought. The problem is made especially acute by the way the Government does its budgeting: an office gets its funding year-by-year, and frequently doesn't know how much it has for a procurement until toward the end of a fiscal year. Then it wants to buy right away,

because the funding won't necessarily be provided next year if it isn't spent this year. Whether the taxpayer gets a good deal is off the radar screen for many of the people in program offices.

For many years, procurement professionals have been the taxpayers' line of defense against these inclinations. The procurement process, within the Government, has traditionally been marked by a creative tension between contracting and program officials. While the program people have wanted to buy things fast and easily, the contracting staff have put competition, with its consequent savings, first. The current regime has tilted the balance of this creative tension. The contracting personnel are having a tough time holding up their critical end of the process, and thereby avoiding being demoted, effectively, from professional managers to clerical assistants.

Contracting personnel also need to be on the lookout, more than ever, to guard against political or unethical influences on procurement decisions. One of the problems with a less structured process is that it makes it easier for people with power to exert improper influences on award decisions. Those of us in the Federal Government procurement community are justifiably proud that with some regrettable exceptions, our procurements have been honest and apolitical. As the culture of procurement changes, we must be on our toes to ensure that this aspect of that culture does not suffer.

I promised you earlier that before concluding, I would discuss a couple of ramifications of the current procurement environment that are important, but rarely mentioned. Let me get to them now.

One is the impact of the past decade's changes on what the Government buys. Under the old style of buying goods and services, which was the paradigm under CICA, an agency had to very carefully decide exactly what it needed to acquire, and then present to vendors a statement of work against which it would solicit bids or offers. The vendors would often ask questions about the agency's requirements in the course of the procurement, thereby forcing the agency to think even more closely about what it needed. Then a contract would be awarded and, usually for a firm, fixed price, the contractor would provide what the agency had requested.

Under the current system, as it has developed over the past decade, an agency doesn't have to perform the hard work of defining requirements, partially in response to vendor questions, before awarding a contract. The agency can simply use one of the non-competitive contract vehicles I described earlier – award a contract on the basis of undocumented oral proposals, place a delivery order against an umbrella or schedule contract, or write a sketchy letter contract – and define its requirements later.

There are two principal problems with this approach. One is that by not thinking through in advance exactly what the agency needs, the program officials may wind up with two unwanted results. First, they may need longer to get the job done, since they will be re-thinking it on the fly. Second, they may also pay considerably more money for the results obtained, since far more of those results will have to be purchased on a time-

and-materials basis. Purchasing on that basis is inevitably more expensive than buying under a firm, fixed price contract arrived at in a competitive environment. It also contains many of the elements of cost-plus-a-percentage-of-cost contracting, which Congress found so disadvantageous that it has prohibited that method from being used.

The other problem is more insidious: The agency officials who enter into the contracts without any concrete idea of their true requirements may never understand exactly what they need, and by default leave to the contractor the opportunity to define the requirements. And of course this situation tempts the contractor to provide not what a conscientious public servant might decide was necessary, if he or she were forced to write a statement of work that would be subjected to careful scrutiny in a competitive procurement, but rather, what the contractor has available to sell – and at the greatest profit margin. I might have spoken too soon in suggesting that the current system tilts the balance too much toward program officials and away from contracting personnel. The system tilts authority away from all Government representatives by making it all too easy for program officials to cede to contractors authority which is properly Governmental.

The other thought I'll leave you with concerns the international ramifications of the current Government procurement system. The United States has been making great efforts to open other governments' markets to fair, open competition in which American companies can participate. As our own Government abandons full and open competition, in favor of efficiency and unchecked discretion to choose business partners on the basis of reputation, how can we look our trading partners in the eye and demand that they do otherwise? For small savings in administrative spending on the procurement process, we may not only be costing the taxpayers big bucks in purchasing costs, but also undermining efforts to open large markets for American capital and labor abroad.

As you can see, I have serious doubts about the wisdom of some of the changes which occurred in the Government contracting world during the 1990's. These changes have attempted to make Government procurement more efficient by misguidedly cutting back on its most important cost-saving feature – full and open competition. Increased administrative efficiency is great. Indeed, it's an essential element of ensuring that taxpayers' money is spent wisely. But in my opinion, many of the changes have been pound-foolish, and some of them not even penny-wise.

I know from my own occupation that efficiency can be over-emphasized. I hear often, as I'm sure you do, that the legal process is inefficient. It takes too long, and it's too burdensome. I once offered parties who made those complaints an opportunity to have a truly efficient proceeding. The parties would not have to discover what really happened regarding their dispute, and they would not have to present the facts through documents and hearing testimony. They would not have to analyze those facts in the context of statute, regulation, and case law, and brief the matter to me. They wouldn't have to wait for me to write a decision. Instead, we would proceed directly to a highly efficient – and incidentally, fair – resolution of the case. I would simply flip a coin, and whoever called it correctly would prevail.

As I pulled a quarter out of my pocket, everyone else in the room began to sputter. Finally someone had the gumption to say that he didn't think it was appropriate to decide a case that way. Then everyone else said the same thing. And of course, they were right. Flipping a coin would have been efficient, but the parties to a lawsuit – and the taxpayers who provide the tribunal which hears it – expect and deserve better. The public demands a judicial system which considers matters presented to it fully and fairly – and efficiently, too, but not efficiently, to the suppression of more critical values.

So it should be with the Government's procurement system, as well. Efficiency and ease of contracting are important. But we have not been careful enough in weighing increases in efficiency against the critically important values of openness, fairness, economy, and accountability. By diminishing those key values, we have damaged the system and created a pseudo-efficiency which, on closer inspection, has resulted in greater costs. The procurement system is far less faithful to the democratic and capitalistic impulses that it once reflected.

By disdaining full and open competition, we have sapped the system's greatest strength. We all know that a genuinely competitive marketplace works to the greatest benefit of all of us as consumers. Why shouldn't this engine of capitalism continue to benefit all of us as taxpayers, too?

Government procurement is an easy target for political rhetoric. But overall, it has been a system we can be proud of. Nearly a century ago, Mr. Justice Holmes wrote, "Men must turn square corners when they deal with the Government." [Rock Island, Arkansas & Louisiana Railroad Co. v. United States, 254 U.S. 141, 143 (1920).] And later Mr. Justice Jackson pointed out that the relationship is mutual: "[T]here is no reason why the square corners should constitute a one-way street." [Federal Crop Insurance Corp. v. Merrill, 332 U.S. 380, 388 (1947) (dissenting opinion).] Government contracting in the United States has been, for longer than any of us can remember, marked by openness, fairness, economy, and accountability.

When people from many other countries hear how our system has worked, they are amazed. Where they come from, those in power award contracts with very little oversight, sometimes to their friends, sometimes even to themselves. That hasn't been our way – and we need to overcome the missteps of the 1990's to make sure it isn't.

An honest, open, fully competitive procurement system has enormous benefits for all of us -- potential suppliers, Government officials, and most important, taxpayers. If we put our minds to it, we can recover that kind of system and make Government contracting more efficient without limiting participation to a favored few contractors.

Boeing Decision Affects Cost Allocation Doctrine

by
Frank K. Peterson *

Recently, in Boeing North American, Inc. v. Roche, CAFC No. 01-1011, July 29, 2002, the United States Court of Appeals for the Federal Circuit (the "Federal Circuit" or the "Court") resolved an ambiguity arising from an earlier opinion by clearly stating that a contractor does not have to demonstrate that costs "benefit the government" before those costs can be allocated to a government contract. While clarifying the allocability issue, however, the decision adds an element of uncertainty for contractors in the area of cost allowability. In *Boeing*, the Court recognized an additional category of unallowable legal expenses – expenses incurred in defense of shareholder lawsuits alleging a contractor's failure to prevent misconduct by the corporation or its employees. Even if the shareholder action is settled, the contractor's legal defense costs would be allowable only if the government contracting officer determined that there was "very little likelihood" that action against the contractor would have been "successful on the merits."

Boeing North American, Inc., a wholly owned subsidiary of The Boeing Company, merged with Rockwell International, a large defense and aerospace contractor, in 1996. Prior to the merger, Rockwell had pled guilty to criminal charges for making false statements and defective pricing in connection with work performed under government contracts and for felony violations of environmental statutes and had settled a civil suit brought under the False Claims Act alleging fraudulent mischarging of the government. In June 1989, four Rockwell shareholders filed a shareholder derivative complaint against the corporation's directors and officers alleging that they had breached their fiduciary duties by failing to establish internal controls to insure that the corporation's business would be carried out in a lawful manner. In October 1991, Rockwell and the plaintiff shareholders entered into a settlement agreement. Rockwell denied liability with respect to any claim in the complaint but agreed to establish an audit committee to oversee corporate activities and to pay plaintiff's legal expenses, amounting to \$1.4 million. In all, Rockwell incurred approximately \$4,576,000 in legal fees and costs in defending and settling the shareholder action. Rockwell included those costs as general and administrative ("G&A") costs in its home office overhead for the years 1989 through 1991 and allocated a portion of those overhead costs to a contract with the Air Force.

In May 1996, the Air Force contracting officer issued a final decision disallowing the costs, concluding that the costs were unreasonable under FAR §31.201-3 and therefore unallowable because Rockwell violated its responsibilities to the government

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and to the public at large. The decision was appealed to the Armed Services Board of Contract Appeals. Boeing, Rockwell's successor in interest, argued that the costs were allowable because they were ordinary, necessary, and allowable "professional services" costs under FAR §31.205-33(b), the costs were reasonable in relation to the services rendered, and the costs were allocable to the contract because they conferred benefit to the contract. The Board denied Boeing's appeal based on its understanding of the Federal Circuit's decision in Caldera v. Northrop Worldwide Aircraft Services, Inc., 192 F.3d 962 (Fed. Cir. 1999). The Board concluded that there could be "no benefit to the Government in a contractor's defense of a third party lawsuit in which the contractor's prior violations of federal laws and regulation were an integral element of the third party's allegations." "But for" Rockwell's improper actions, the shareholders' suit would not have been brought and the costs would not have been incurred. Boeing appealed the Board decision to the Federal Circuit.

The Court issued an opinion on March 15, 2002, concluding that the Board committed legal error in determining the allowability of Rockwell's defense costs based on whether the costs conferred a "benefit [on] the Government" and the "but for" standard that looked solely to the fact that admitted misconduct by Rockwell formed the basis for the shareholders' complaint. The Board's decision was vacated and remanded with the Court's guidance that "the Board may allow the costs only if it determines that the plaintiffs in the [shareholders'] lawsuit had 'very little likelihood of success on the merits' of prevailing." On July 29, the Court, acting *en banc*, vacated that judgment and issued a revised opinion. The revised opinion did not change the Court's conclusions. Rather, it changed how the Court reconciled the opinion with an earlier, seemingly contradictory, opinion.

The Court began its analysis by distinguishing cost allowability and allocability. The Court explained that the concept of allowability deals with whether a particular item of cost should be recoverable from the government in whole or in part as a matter of public policy. The concept of allocability is addressed to the question of whether a sufficient "nexus" exists between the cost and a government contract. Cost allocability is to be determined under the Cost Accounting Standards ("CAS"). Allowability of a cost is governed by the Federal Acquisition Regulation ("FAR"), i.e., the cost principles expressed in Part 31 of the FAR and pertinent agency supplements.

That rather straightforward differentiation between allowability and allocability had been confused by language in the *Northrop* decision, *supra*, in which the Court concluded that a contractor's legal defense costs of a lawsuit involving a judicial determination that a contractor had induced its employees to commit fraud against the government were not allocable "because they did not benefit the government." In its revised opinion, the Court went to great lengths to explain why that part of *Northrop* was not binding precedent.

The Court explained that allocability is an accounting concept and that CAS does not require that a cost directly benefit the government's interests for the cost to be allocable. The word "benefit" as used in the allocability provisions of FAR § 31.201-4

describes the nexus required for accounting purposes between the cost and the contract to which it is allocated. The requirement of a "benefit" to a government contract is not designed to permit "an amorphous inquiry" into whether a particular cost sufficiently "benefits" the government so that the cost should be recoverable from the government. The Court explained that determining whether a cost should be recoverable is to be done by applying the FAR allowability provisions, which embody the government's view, as a matter of "policy," as to whether the contractor may permissibly charge particular costs to the government (if they are otherwise allocable).

The Court then addressed Boeing's argument that the costs for professional services were allowable because they were not specifically disallowed under the FAR provisions dealing with costs related to legal and other proceedings. The Court rejected the contractor's position and instead looked to the language in FAR §31.204(c), which states "[t]he determination of allowability shall be based on the principles and standards in this subpart and the treatment of similar or related selected items."

The Court interpreted *Northrop* and FAR §31.205-47 (Costs related to legal and other proceedings) as "establish[ing] a simple principle – that the costs of unsuccessfully defending a private suit charging contractor wrongdoing are not allowable if the 'similar' costs would be disallowed under the regulations." The Court recognized that the regulations disallowing certain costs "do not address costs similar to the costs of defending a contractor's directors from charges that they tolerated inadequate controls concerning possible fraud or similar misconduct." Since the costs were not "similar", the Court looked to the second prong of its analysis — whether the costs were "related" to a category of disallowed costs, i.e., the costs of defending against government charges of contractor wrongdoing.

The "related" test could not be met simply because a cost would not have been incurred but for the occurrence of an event that resulted in a disallowed cost. The Court stated that there must be a "more direct relationship to the disallowed cost." That "direct relationship" could have been demonstrated by a judicial determination that the Rockwell directors had failed to maintain adequate controls to prevent the occurrence of wrongdoing. However, since the case was settled and no such finding was made, the Court felt that it must do further analysis.

The Court looked to the regulations dealing with the disallowance of costs where an action is brought by a federal or state government entity. In those circumstances, legal defense costs would be disallowed in the event of a conviction, a finding of a violation, or a decision to debar or suspend the contractor, rescind or void the contract or terminate the contract for default. Even in the event of a settlement, the defense costs would be disallowed, unless the government specifically agreed that they would be allowable. The Court reasoned that the policy was based on the assumption that suits brought by governmental entities were in most situations likely to be meritorious, justifying a bright line rule that does not look behind the settlement. The Court, however, felt that such an assumption was not appropriate when the suit was brought by a private party and settled.

In settlements of private suits, the Court looked for similar circumstances covered by the FAR and found one in FAR §31.205-47(c)(2). That provision states that legal costs incurred in the event of a settlement of any proceeding brought by a third party under the False Claims Act in which the United States did not intervene may be allowed if the contracting officer “determines that there was very little likelihood that the third party would have been successful on the merits.” The Court considered this to be “an appropriate standard for private suits in the present context” and concluded that for the costs to be allowable in the settlement situation, “Boeing must show that the allegations in the [shareholders’] action had ‘very little likelihood of success on the merits.’”

The decision is a mixed blessing for federal contractors. On the one hand, it settles the question of whether a contractor must be able to prove the amorphous proposition that a cost is of benefit to the government before it may be allocated to a contract. On the other hand, *Boeing* opens a wider range of a contractor’s legal expenses to a finding of unallowability. In the event of a shareholder lawsuit against a contractor and its officers and directors related to “any proceeding brought by a Federal, state, local or foreign government for violation, or failure to comply with, law or regulation”, FAR §31.205-47(b), the costs associated with defending against the shareholder action may well be unallowable. If the contractor admits wrongdoing or if the government action results in a finding against the contractor, the costs of defending against the shareholder suit will be unallowable unless the contractor 1) obtains a judicial determination in its favor in the shareholder action or 2) settles the case and then meets the burden of proving that the shareholder action had “very little likelihood of success on the merits.” In either event, the contractor will be forced to incur additional costs to justify its legal expenditures related to the shareholder action.

Canada's Bid Protest Process: An Introduction

by

Christopher R. Yukins

On January 1, 1994, the North American Free Trade Agreement (NAFTA) came into effect. Under Article 1017 of NAFTA, the signatory nations are required to establish bid protest processes for challenges to public procurements.¹⁵ The elements of the required bid protest process are, in essence, the elements of the existing U.S. bid protest process:

- NAFTA's Article 10 required signatory nations to establish impartial fora to hear bid protests.
- These fora are to require protestors to bring challenges in a timely manner, at a minimum of ten days after discovery.
- The fora are to recommend resolutions to awards that are tainted by improper procurement procedures.
- The governments of the respective signatory nations are allowed to override the bid protest fora, if so required by the national interest.

Although the U.S. bid protest system was already in place, Canada vested the new authority in the Canadian International Trade Tribunal (CITT). The CITT has concurrent jurisdiction to hear challenges under other agreements requiring fair competition in Canadian procurement.

In general, the processes of the CITT are similar to those of the General Accounting Office in the United States. The process is initiated by a complaint to the CITT, a copy which is sent by the CITT to the government institution conducting the procurement under protest. The CITT will decide whether or not to conduct an inquiry within five working days after the complaint is filed; contrary to U.S. practice, notices of the inquiry are published in widely distributed Canadian government publications. If the contract has not been awarded, the CITT may order the government agency to postpone an award until a complaint has been considered. As is generally the case in the United States, if the government agency certifies that the procurement is urgent or that the delay would be against the public interest, the contract may be awarded despite the protest.

Within 25 days after notice of the complaint in the Canadian process, the government agency must file a report with the CITT. This is similar to the GAO practice in the United States, under which the agency must file an "agency report." The CITT will send a copy of the report to the complaining party and the intervenor (generally the successful bidder, though under Canadian practice an intervenor is any "person who has a

direct interest in the complaint”). The complainant and the intervenor may provide comments to the CITT within seven days.

In a departure from U.S. practice, during the period provided for an agency report and comments from the parties, under the Canadian procedures the CITT may conduct a staff investigation, which may include a review of relevant procurement files. If this occurs, the CITT will prepare and distribute to the parties a staff investigation report, to which the parties may respond.

As in U.S. procedures, the CITT may hold a hearing before issuing a decision. Typically, the determination is made by the CITT within 90 days after the filing of the complaint. Decisions of the CITT are available online, at www.citt.gc.ca.

**Proposed Changes
to the
Boards of Contract Appeals Bar Association
Constitution and By-laws**

Under Article IX of the BCABA Constitution, the following changes are proposed to the BCABA Constitution:

Proposal 1: Change all "President-elect" references in the Constitution to the "Vice-President."

Rationale: The position title is being changed in the by-laws.

Proposal 2: Change Section 2.3 of the Constitution, and other references to "Associate members," as follows:

Section 2.3 ~~Honorary Associates-Members~~. The judges of the Boards of Contract Appeals and such others as the Board of Governors designates may be honorary associates of the Association, provided, however, that nothing herein shall preclude any honorary ~~associate~~ member from application and acceptance as voting members of the Association in accordance with the By-laws of the Association.

Rationale: Judges have always been referred to as "honorary members," not "honorary associates."

Under Article VIII of the BCABA Constitution, the following changes are proposed to the BCABA By-laws:

**Proposed Changes
to the
Boards of Contract Appeals Bar Association
By-laws**

**Article I
Members and Associates**

Section 1.1. Application for Membership. Any eligible person may file with the Secretary an application for membership in the Association in the form prescribed by the Board of Governors along with the requisite dues. The Board of Governors may require the applicant to furnish additional information and may otherwise inquire into his or her qualifications. A willful and material misstatement by the applicant is cause for rejecting the application or, if he or she has been elected to membership, for expelling the member. Unless the Board of Governors rejects the application for membership at the next meeting of the Board of Governors, the application will be deemed approved. In the interim between application for membership and the next meeting of the Board of Governors, the applicant shall be treated as though he or she is a member of the Association.

Section 1.2. Dues. A member of the Association shall pay dues in the amount prescribed from time to time by the Board of Governors. Honorary associates, as defined in Section 2.3 of the Constitution, shall pay no dues. Membership shall include the member's annual subscription to the Association's publications.

Proposal 3: Change Section 1.3 of the By-laws as follows:

Section 1.3. Default in Payment of Dues. A person whose dues are ~~six~~ ~~months~~ in default ceases to be a member of the Association.

Rationale: A member who does not pay dues ceases to be a member until the dues are paid.

Section 1.4. Reinstatement of Members. A person whose membership has terminated may be reinstated only upon a new application as prescribed in Section 1.1.

Article II Reports and Recommendations

Section 2.1. Association Action. A report or recommendation of a committee becomes the action of the Association only so far as it is approved by the Board of Governors.

Section 2.2. Distribution of Reports. A report or recommendation of a committee may not be released to the public before consideration and approval by the Board of Governors.

Section 2.3. Restrictive Statement. Before approval by the Board of Governors, any material containing a report, recommendation or proposal must prominently state at the outset that it represents the opinion of the committee making the report rather than the position of the Association.

Article III
Representation of the Association

Section 3.1. Representation. The President or a person expressly designated by the President shall express the policy of the Association as determined by the Board of Governors. No other member, agent or employee of the Association may represent the Association or a committee of the Association before a legislative body, court or government agency, unless specifically authorized by the Board of Governors.

Section 3.2. Personal Views of Members. Any member who, when making a public statement, is identified as having an official connection with the Association or one of its committees, shall, if the policy of the Association on the subject matter of the statement has been determined by the Board of Governors, fairly state that policy and, if such member expresses views at variance with it, clearly identify the variance as the personal views of the member only. If there has not been, or if the member has no knowledge of, any such policy determination, the member shall nevertheless identify the member's statements as the member's personal views.

Article IV
Finances and Activities

Section 4.1. Authority to Incur Expense. The Board of Governors shall formulate and administer Association policy respecting authorized expenditures and procedures for reimbursement.

Proposal 4: Change Section 4.2 of the By-laws as follows:

Section 4.2. Payment of Authorized Expenses. The Treasurer shall disburse all funds, but may only pay expenses authorized by the Board of Governors that are within budget appropriation, and shall not disburse any amount in excess of \$500 without the approval of the Board of Governors. The bank account of the Association shall be maintained at a financial institution in Washington, D.C. Any withdrawal of funds by check or cash shall be signed by the Treasurer and/or by such other person or persons as may be designated by the Board of Governors. All payments to Association officers must first have the approval of two members of the Board of Governors, which will be reflected in the financial records.

Rationale: Install better financial controls.

Section 4.3. Expenses at Meeting. A member of the Association may not be reimbursed from Association funds for travel or other expenses incurred in attending a meeting of members.

Section 4.4. Financial Liability. The financial liability of the Association to any committee is limited to the funds credited to it on the financial record of the Association, and the liability ceases upon the Treasurer's payment of that amount. If a committee, or one of its members, incurs a liability that is greater than the funds so credited, the liability is the obligation of each person responsible for incurring or authorizing the liability.

Proposal 5: Change Section 4.5 of the By-laws as follows:

Section 4.5. Insurance Coverage.

- ~~(a) The Treasurer of the Association shall be bonded in an amount determined appropriate by the Board of Governors.~~
(b) The Association shall carry such insurance as the Board of Governors deems appropriate.

Rationale: No Association Treasurer has ever been bonded. Moreover, personal bonds can only be obtained for a minimum of \$25,000, an amount higher than the Association's treasury.

Proposal 6: Add the following section to the By-laws:

Section 4.6. Dues.

- (a) Dues notices will be distributed to the membership in August for payment not later than September 30th. Honorary members are not required to pay dues, but may voluntarily pay dues at the government member rate.
(b) Annual dues may only be changed by a two-thirds vote of the Board of Governors.

Rationale: This formalizes present Association policy.

Proposal 7: Add Section 4.7 to the By-laws as follows:

Section 4.7. Publications.

- (a) Directory. A directory will be published in October and distributed to each member and honorary member. No advertisements are permitted in the directory.
(b) The Clause. The Clause is the quarterly publication of the Association, and will carry articles, announcements and information of interest to the government contract community. The Association will timely publish and distribute to the membership each issue of The Clause. There is no publication limit for any issue, and no advertisements are permitted.

Rationale: This also formalizes present Association policy.

Proposal 8: Add Section 4.8 to the By-laws as follows:

Section. 4.8. Annual Meeting. The annual meeting of the Association will normally be held in October. The cost of the annual meeting shall be largely borne by the annual meeting attendees. However, the Association will retain any surplusage or be liable for any shortfall resulting from the costs of annual meeting.

Rationale: Formalizes present Association policy.

Article V
Duties of Officers

Proposal 9: Make the following changes to Section 5.1 of the By-laws:

Section 5.1. President. The President shall preside at the meetings of the Association and of the Board of Governors. The President shall supervise and be responsible for all activities of the Association, and may appoint the chairperson and members of each committee of the Association ~~and of the Board of Governors.~~ Any action of the President that will cost the Association more than \$500 must first have the approval of a majority of the Board of Governors.

Rationale: Formalizes Association policy previously approved by the Board of Governors.

Proposal 10: Make the following changes to Section 5.2 of the By-laws:

Section 5.2. ~~President-Elect.~~ Vice-President. The ~~President-Elect~~ Vice-President shall perform such duties as the President may assign and, except as otherwise provided, the duties of the President when the President is disabled from performing the duties of President or absent from any meeting of the Association or the Board of Governors. The ~~President-Elect~~ Vice-President shall automatically succeed to the position of President at the next installation of officers.

Rationale: Replaces the confusing "president-elect" title to "vice-president."

Proposal 11: Make the following changes to Section 5.3 of the By-laws:

Section 5.3. Secretary. The Secretary shall:

- (a) keep the respective minutes and records of the Association and the Board of Governors;

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- (b) ~~receive, certify and publish nominations of officers and governors at large, and supervise their election;~~ ensure that the annual dues notices are issued in August;
 - (c) receive and keep as the property of the Association all papers, addresses and reports to the Association or the Board of Governors;
~~and~~
 - (d) give notice, when notice is required to be given, to the Board of Governors and/or the members of the Association; and
 - (e) ensure that a directory is published and distributed to each member in October.

The Secretary shall automatically succeed to the position of Vice-President at the next installation of officers.

Rationale: Formalizes administrative responsibilities.

Proposal 12: Make the following changes to Section 5.4 of the By-laws:

Section 5.4. Treasurer. The Treasurer shall supervise the safekeeping of the funds and investments of the Association and shall report ~~periodically~~ quarterly on the financial condition of the Association to the Board of Governors. A Statement of Financial Condition will also be published by the Treasurer in each issue of The Clause. The Treasurer's annual report shall be submitted to the Board of Governors for examination at the annual meeting, and ~~audit~~ may be audited by a certified public accountant designated by the ~~President.~~ Board of Governors.

The Treasurer shall automatically succeed to the position of Secretary at the next installation of officers.

Rationale: Formalizes current practices of the Association.

Proposal 13: Eliminate Section 5.5 of the By-laws:

~~Section 5.5. Administrative Officer. Any administrative officer appointed by the Board of Governors shall administer the staff and facilities of the Association, subject to the direction of the President and the Board of Governors.~~

Rationale: The Association has never had an "Administrative Officer," "staff" or "facilities."

Proposal 14: Add a new Section 5.5 to the By-laws as follows:

Section 5.5. Succession of Officers. Should a vacancy occur in any of

the officer positions, a replacement will be selected by a majority vote of the Board of Governors.

Rationale: When there was a vacancy in one of the officer positions, there were no procedures regarding how to address it. This remedies that defect.

Proposal 15: Add a new Section 5.6 to the By-laws as follows:

Section 5.6 Removal of Officers. Any officer of the Association may be removed from office during their term by a two-thirds vote of the Board of Governors.

Rationale: There is currently no procedure concerning removal of officers.

Article VI Committees

Section 6.1. General Duties. A committee shall carry out its duties to the extent and in the manner authorized by the Board of Governors.

Section 6.2. Appointment. Unless the resolution creating the committee provides otherwise:

- (a) appointments to a committee, including the annual appointment of its chairperson, shall be made by the President.
- (b) if the chairperson or a member of the committee resigns, dies or becomes ineligible, the President shall appoint a successor for the unexpired term.

Section 6.3. Standing Committees. Standing Committees shall investigate and study continuing or recurring matters relating to the purposes or business of the Association.

Article VII Election of the Board of Governors and Voting

Section 7.1. Majority Vote. In any election of the Board of Governors or in any other matter on which the membership shall vote, the Board of Governors shall determine the manner in which such voting shall be conducted. Except as otherwise provided in the Constitution of the Association, a majority of those voting shall be required. A quorum shall be 5% of the Association membership or fifty members of the Association, whichever is less.

Proposal 16: Make the following change to Section 7.2 of the By-laws:

Section 7.2. ~~Ballot~~ Elections by Mail. If the Board of Governors determines that an election or voting by the members of the Association shall be conducted by mail, a written ballot shall be mailed by the

Secretary, or the Secretary's designee, to each member in good standing of the Association along with a return envelope, another envelope marked "Ballot Only" and a separate certificate bearing a space for the signature and the address of the member voting. Such material shall be mailed no less than thirty days before the election or vote for which the ballot is sent. Each member of the Association shall, within the time specified in the notice accompanying the ballot, complete and return the member's ballot in the envelope marked "Ballot Only," and shall accompany it in the returned envelope (but not in the "Ballot Only" envelope) with the signature and address form completed by the member. As soon as practicable after the return date specified in the notice, the Secretary, or the Secretary's designee, in the presence of three impartial canvassers appointed by the President, shall canvas those ballots which have been received by the Secretary, by 5:00 p.m. on the day specified in the Secretary's notice, and tabulate the results of the election or the vote.

Rationale: The provision was inappropriately titled, and the change corrects that.

Proposal 17: Add Section 7.3 to the By-laws as follows:

7.3. Elections. Unless the Board of Governors determines that an election or voting by the members of the Association shall be conducted by mail, all elections of officers and governors will be done by a majority vote of the members during the installation of officers session of the annual meeting. Members not attending the annual meeting may vote by proxy.

Rationale: Formalizes Association practice.

Article VIII
Calendar Year

Proposal 18: Make the following changes to Section 8.1 of the By-laws:

Section 8.1. Calendar Year. The Association shall have a ~~calendar~~ fiscal year from October 1 to September 30.

Rationale: Formalizes Association practice.

With the approval of the Board of Governors, the BCABA membership will vote on these proposed changes at the annual meeting on October 23, 2002.

TREASURER'S SUMMARY REPORT

**BCA Bar Association
Statement of Financial Condition
For the Period Ending 16 August 2002**

Balance Beginning 7/1/02		\$15,911.18
Fund Income:		
	Membership Dues & Electronic Fund Transfers:	\$4,623.08
	Total Fund Income:	<u>\$4,623.08</u>
Subtotal:		\$20,534.26
Fund Disbursements:		
	Paid Expenses	\$184.86
	Total Fund Disbursements:	<u>\$184.86</u>
Ending Cash Balance:		\$20,349.40

Joseph McDade
Treasurer