In the first part of this 2-part article, we discussed the interesting **CBCA decision** that Stephen Avery brought to our attention. As noted in Part 1, this was an acronym-filled decision and, if you didn't start by reading Part 1, we expect you'll get lost. So go read **Part 1** now, please.

Let's recap a bit: The dispute was ostensibly about claimed costs in a subcontractor's termination for convenience settlement proposal but really seemed to center on the subcontractor's lack of final billing rates. DCAA had audited the subcontractor's ICS for its FYs 2003 through 2007 but it took until the actual filing of the claim before the CMS contracting officer got around to unilaterally establishing final rates for those years. Final rates for the subsequent years were never established, even though DHHS/CMS auditors spent at least two years auditing them.

The prime (GHI) claimed it could not reach a final settlement on the subcontractor's (DCCS) termination settlement proposal without final billing rates. The subcontractor claimed on-going costs related to supporting the incurred cost audits and in supporting close-out of its subcontract. For its part, the government customer (DHHS/CMS) asserted that it had no role in negotiations between a prime contractor and its subcontractor while at the same time telling the prime contractor that the on-going costs claimed by DCCS were both unreasonable and unallowable.

Before the Board were dueling motions for summary judgment.

The government first argued that the post-termination costs claimed by DCCS were unreasonable and unallowable, because they were due to the "willful failure of the [sub]contractor to discontinue costs." The government argued that it was "unreasonable" for DCCS to be put in a better position, financially speaking, than if the contract had been allowed to run its course. In this vein, the government noted that the contract, by its terms, ended in November, 2011. Thus, costs incurred after that date were unallowable.

The government's second argument was that DCCS' claimed costs were "not supported by accounting data and other information sufficient for review by the government." The government asserted that DCCS' alleged failure to provide required supporting documentation

"interfered with CMS's ability to consider which charges might constitute allowable charges."

With respect to the government's first argument, DCCS argued that it had "an unavoidable contractual obligation to support the Government's audit of its termination settlement proposal and indirect cost rates for all open years." DCCS argued—

Had CMS audited and settled the open contract years or negotiated the termination settlement proposal in a timely manner, DCCS could have placed all of the audited records in permanent storage and discontinued operations. However, CMS did not do either of these things. Instead, CMS required DCCS to undergo a protracted audit. As a consequence, DCCS was compelled to continue to incur costs in order to close out the subcontract in accordance with the requirements of FAR 52.216-7.

In addition, DCCS asserted that it was not seeking to better its financial position as the result of its claimed costs. Instead, DCCS argued –

Even if the subcontract had run its normal course, the post-completion costs incurred by DCCS in supporting the Government's audit and settling final indirect cost rates would still be allowable and allocable to the subcontract. Contractors frequently continue to incur costs for this purpose after the end of a physically complete cost reimbursement contract since final indirect cost rate proposals are not submitted until after the end of each fiscal year.

With respect to the government's second argument, DCCS countered that it had made all of its accounting data and other supporting information available for CMS review, but that the CMS auditor(s) "declined to review it." Thus, DCCS argued that the government's "real complaint" was that —

… DCCS declined to make copies of the supporting data, but nothing in DCCS's subcontract or the FAR requires a contractor or subcontractor to incur the cost of copying voluminous records that are otherwise made available for the Government's review and inspection. DCCS fully satisfied its contractual obligation by offering to make the records available for CMS's examination, audit and reproduction

The CBCA resolved the parties' arguments by ruling that DCCS was entitled to its post-termination costs. As Judge Goodman wrote for the Board—

First, respondent implies that DCCS's costs continued after the effective date of the termination due to the willful failure of the contractor to discontinue costs. There is no evidence to support this allegation of willful failure to discontinue the types of costs sought by DCCS. Respondent also alleges that the magnitude of the costs claimed by DCCS is out of proportion to those incurred by subcontractor in responding to the audit of its indirect costs through 2011. However, respondent's allegation focuses on DCCS's response to the audit, and does not take into account the alleged costs for migration and storage of information after termination. Allegations as to magnitude of costs do not defeat entitlement to such costs, but only raise questions as to quantum

There will still need to be a trial to decide quantum, unless the parties are able to reach a settlement beforehand.

In the first part of this 2-part series, we related two lessons that Stephen Avery took away from this decision. We would like to add our takeaways, as well.

First, as we've written before, we believe that once a contractor (or subcontractor) has submitted a proposal to establish its final billing rates, then the government has a duty to audit that proposal in a timely manner. There is nothing in the FAR that establishes what "timely" means in this context, but we believe that the government has a duty to move with reasonable dispatch. In this case, the government had audit reports from DCAA for 4 years' worth of incurred cost, but failed to do anything with those reports. That smells like negligence and a potential contract breach to us.

Second, we think GHI took an incorrect position, in that it assumed it could not finalize contract costs without a set of government-approved final billing rates. As we've written **before** , the government is not a party to negotiations between a prime and its subcontractors; the government's determination of provisional and/or final billing rates is not dispositive with respect to those negotiations. What that means is that GHI could have always entered into negotiations with DCCS and established final billing rates with respect to the subcontract and with respect to the termination settlement proposal. The government audit of DCCS' proposed final billing rates was irrelevant to the two parties' discussions.

Yes, the prime contractor is taking some risk. It is taking the risk that the final billing rates it negotiates with the subcontractor may include costs found to be unallowable by the official government audit, whenever it is performed. But that risk can be mitigated. It can be mitigated through representations and it can be mitigated through indemnification.

More importantly, consider that—in this case if in no other—an early finalization of indirect cost rates and an early negotiation of the termination settlement proposal and an early close-out of the DCCS subcontract would have avoided nearly $1 million worth of costs. Not to mention it would have avoided a protracted dispute involving several sets of very expensive attorneys—costs that are very likely to be unallowable.

Taken as a whole, we think the correct answer is obvious and we hope our readers do better than GHI with respect to the issue of subcontractor rate finalization and close-out.

Finally, the third point is less black-and-white and more of an opinion based on many years of doing this work. A contractor (or subcontractor) has a choice regarding its cost accounting practices. Just because a cost *can* be allocated to a final cost objective as a direct cost doesn't mean that it *has* to be treated as a direct cost. With respect to this particular case, DCCS could have chosen to treat audit support and contract close-out tasks as indirect activities, which means that they would be absorbed into overhead and not charged as direct costs to the subcontract.

When you charge audit support and contract close-out tasks as direct costs, you create several problems. First, you have to propose those costs and get them priced and funded. Second, you have to have funds left over after performance to cover those tasks. Finally, you create a never-ending cycle, because each year of audit support creates more direct costs that have to be billed and supported through audit. You never ever finish charging direct costs, unless you charge them as non-billable, which means margin erosion. Far better—in our mind at least—to stop the direct charges as soon as possible so that the final contract costs can be determined. Thus, we are strongly biased towards treating those tasks as indirect activities.

Assuming that DCCS had more than one cost-type contract and thus submitted an annual final billing rate proposal and support the audit of that proposal regardless of whether its GHI subcontract was active, then that approach would have gone a long way towards proactively

solving the problems that ultimately led to the litigation in which it found itself—litigation that is apparently *still ongoing*. Obviously if the only cost-type contract DCCS had was its subcontract with GHI, then that logic really doesn't work. But for many of our readers, that logic will work and it makes good sense to us to move in that direction.

So, to wrap up this 3,200 word deep-dive into one CBCA case, let's recap the takeaways.

From Stephen Avery we should remember that, while cooperation with government auditors is of paramount importance, a contractor does not have to bend over backwards in order to support an audit. The contractual responsibility is to provide accounting records and other supporting information to the auditor(s) as requested; but there is no contractual responsibility to make copies of those records or to provide them in electronic format.

From Apogee Consulting, Inc., we hope you will remember that the contractor (or subcontractor) should make every effort to push the government into performing an audit of the annual final billing rate proposal, and should call-out unreasonable delays in performing those audits or in negotiating final billing rates once those audits have been completed.

In addition, we hope you will remember that the prime contractor (or higher tier subcontractor) is responsible for negotiating final billing rates with respect to its subcontracts, and the government is not a party to those negotiations. As a prime, you can—*and you should*—establish final billing rates for your cost-type subcontracts as quickly as possible, so as to avoid unnecessary costs. As a subcontractor, you should proactively push your prime to come to the negotiating table.

Finally, think about how you treat the activities such as preparation and audit support of the annual final billing rate proposal, and contract close-out. Consider whether it makes more sense to treat them as indirect activities. If it makes sense to do so, document that decision and follow it consistently.