People who don't know very much about government contract cost accounting and associated compliance rules think it's just a matter of reading FAR and CAS, and there you go. Just read the rules and follow them. How hard can that be?

People who know more about the topic realize that it's not only a matter of an individual's interpretation of the regulations. You also need to have a basic familiarity with judicial decisions that have supplied the official interpretation. You need to understand how judges (particularly those at the Armed Services Board of Contract Appeals and the Court of Federal Claims) have interpreted those regulations and rules. And you probably need to know whether the U.S. Court of Appeals (Federal Circuit) has sustained or remanded those decisions. You don't need to be a lawyer but it helps to have read a few legal decisions.

People who know a lot about the topic realize just how complex it is. It's not just all of the foregoing; there are new issues constantly being raised. The truth of the matter is that reality is more complicated than the regulations can possibly envision, and so new issues arise and need to be addressed. It's a never-ending cycle and people who do this for a living understand just how complicated some of the issues that arise can become.

Today's article is about one such issue. It's so complicated that we skipped writing about it in 2014, when the **first ASBCA decision** was issued. It's so complicated that we debated for some time before writing about it today, just after the **latest ASBCA decision** was issued. Finally we decided to acknowledge the decision without getting into the (complex and complicated) details, just as a lesson regarding how deep the government contract cost accounting rabbit hole can go.

At stake was some $253 million dollars. As we've stated before, when the government decides to question big dollar costs, contractors *will* lawyer-up. They *will* fight. The stakes are too high. This is one of those times where there was so much money at stake that Northrop *had* to litigate the issue.

Note that we are not lawyers, we are not actuaries, and we are not experts in the accounting requirements associated with Post Retirement Benefits (PRBs). Northrop Grumman was

represented by the top-tier inside-the-Beltway law firm of Crowell & Moring, and if you want better information we suggest you reach out to the attorneys who litigated the matter on Northrop’s behalf.

All that being said, here is a brief summary of the facts as we understand them.

1. Prior to 1995, Northrop Grumman (NGC) accounted for the cost of its PRB expenses using a method that conformed to the requirements of the 1984 Deficit Reduction Act (DEFRA), using generally accepted actuarial principles.
2. In 1995, the FAR was revised at 31.205-6(o). The government’s position was that the revised FAR required NGC to change its PRB accounting methodology, and to fund its PRB liability before filing of Federal income tax returns.
3. Between 1995 and 2006, NGC continued to account for its PRB costs using the DEFRA methodology. “NGC documented its accrual costing method in the company's cost accounting standards (CAS) Disclosure Statement that was reviewed and approved by the government. No allegation was made during that period that NGC's accounting for the Plan's PRB costs using the DEFRA method was noncompliant with NGC's disclosed practices or with CAS. Further, during that period, no unallowable Plan costs were identified by DCAA in any audit of the NGC Corporate Home Office final indirect cost submissions for any period between 1995 and 2005 (the last year audited).”
4. In 1990, the Financial Accounting Standards Board (FASB) issued FAS 106, which required a different PRB accounting method than was permitted by DEFRA. NGC implemented FAS 106 for financial reporting purposes (as it had to), but continued to use its DEFRA methodology for government contract cost accounting purposes until 2006. Importantly: “*NGC's PRB costs calculated during this period were less than the costs would have been had NGC instead used FAS 106 to measure and assign costs.*” (Emphasis added.)

5. Starting in 2006, NGC entered into discussions with DCMA regarding its PRB accounting methodology. NGC initially proposed continuing to use its DEFRA methodology but, after that approach was rejected, it proposed transitioning to the FAS 106 methodology. NGC attempted to obtain an Advance Agreement for its practices, but DCMA declined.
6. The government asserted that, had NGC used the FAS 106 method after 1995 (as it contended FAR 31.205-6(o) required), it would have had higher PRB expenses in those years. In the government’s view, NGC’s methodology shifted PRB costs from past years to future years. Because NGC hadn’t funded its PRB liability in the current period, those future costs were unallowable. “If NGC had used the FAS 106 method instead of DEFRA, the costs assigned to that period [1995 to 2006] would have been approximately $253 million more (the amount of the disallowance) than were assigned under DEFRA.”
7. Importantly: “At some future point, costs calculated using the DEFRA method would exceed FAS 106 calculated costs, barring reduction in Plan benefits. NGC's position is that when and if the cross-over occurred, allowable costs would be limited to the amounts calculated using FAS 106 (pursuant to FAR 31.201-2(c)).”

8. In the first decision, addressing entitlement only, the Board found that "for government contract accounting purposes, NGC failed to measure, accrue, assign and fund its PRB costs in accordance with FAS 106 and FAR 31.205-6(o) allowability criteria during FYs 1995-2006, prior to NGC's 2006 'transition' to the FAR-compliant methodology."

9. However, in the second decision, addressing quantum (the amount NGC would owe the government for its failure to comply with the regulatory requirements), the Board found that "the government unreasonably interpreted the cost principle and ultimately suffered no damages as a result of appellant's use of DEFRA from 1995-2006 for government accounting purposes because of appellant's 2006 Plan amendment implemented concurrently with NGC's transition to FAS 106."

See? We told you it was complicated.

Another important point is that *DCMA's own Contractor Insurance/Pension Review experts disagreed with the position taken by DCMA and, ultimately, the government at trial*. The DCMA's own actuarial experts were fine with the methodology that NGC used, and they were not at all worried about cost-shifting.

So where did the disallowance come from? Where did the DCMA's initial disallowance and Contracting Officer Final Decision come from?

You guessed it.

DCAA.

From the (second) ASBCA decision—

NGC discussed the possible changes with the DCAA auditor who had been primarily responsible for auditing NGC's PRB costs during most of the period at issue. In those conversations, the auditor suggested that the DEFRA method was not compliant with the FAR and that NGC might have created a pool of 'forever unallowable' costs by failing to accrue and charge the maximum amount permitted by the FAR.

This is not the first time a DCAA theory has been rejected by a Court, as documented on this blog. When will DCMA contracting officers stop relying on DCAA auditors for anything other than audit findings? We noted that Northrop tried several times to avoid this dispute, but DCMA (possibly spurred on by DCAA) was having none of it. We’re sure that $253 million in questioned costs looked great to Fort Belvoir and was a nice addition to the DoD OIG Semi-Annual Report to Congress, but the fact of the matter is that the auditor’s flawed legal theory—which was contrary to the findings of the DCMA actual experts—wasted millions of taxpayer dollars.

Anyway, let’s wrap this up by quoting at length from the Board’s decision, written by Judge Peacock.

We consider that FAR 31.205-6(o), properly construed, establishes a cost allowability ‘ceiling,’ and focuses on whether the contractor overcharged the government for PRB costs in its relevant cost-related submissions. There is no dispute that for more than a decade preceding the ‘transition’ NGC did not. From the onset of the FAR requirement in 1995 through 2006, NGC's use of the DEFRA method resulted in the contractor annually charging the government *less* than it could have claimed had it elected to use the FAS 106 methodology for government accounting purposes during those pre-transition years. For that decade, the government unsurprisingly did not object. In fact, the government was well aware that appellant continued to use the DEFRA methodology but repeatedly approved its use as being in compliance with regulatory criteria. …

Interpretation of the provision with respect to ‘quantum’ was not even clear and uniform within the government. The CIPR team's analysis and interpretation differed from that proffered by DCAA and ultimately adopted by the DCE. We consider that the CIPR team correctly interpreted the principle in the first instance. …

The government interpretation advocated in this appeal regarding the pre-transition years also contradicts the general rule regarding the quantum consequences of noncompliance prescribed in FAR 31.201-2(c). That provision states, ‘When contractor accounting practices are inconsistent with this Subpart 31.2, costs resulting from such inconsistent practices *in excess* of the amount that would have resulted from using practices consistent with this subpart are unallowable.’ Here, NGC failed to comply with the FAR requirement that allowable costs be accrued in accordance with FAS 106 criteria where an accrual methodology was used by the

contractor to determine its allowable PRB costs. Although appellant failed to use the proper accrual methodology, there is no evidence or government contention that the amount accrued by appellant pursuant to DEFRA in the pre-transition years
exceeded
the amount of costs that would have been allowable applying FAS 106 or even an amount calculable for the Plan using the 'pay-as-you-go' methodology. In fact, precisely the opposite is true. …

The requisite PRB funding levels (and costs flowing therefrom) are for NGC to determine. … It is illogical and shortsighted for the government to interpret the provision in a manner dictating that appellant *must* charge or *should have* charged the government the full FAS 106 amount, where the contractor determines it is not necessary to pay that full amount to attract and maintain a quality workforce. If NGC had done so, presumptively the excess compensation cost would also be unreasonable as beyond its agreement with covered employees as reflected in the Plan. The assignment and funding requirements are designed to protect the government from paying *excessive* costs. Any 'failure' to assign and/or fund, whether the result of the contractor's best business judgment or other factors specific to the contractor, benefits the government. …

Company-specific PRB costs in this appeal are not 'incurred' for government contract accounting purposes based on generic FAS 106 requirements established for purposes of cross-corporate financial comparisons and standardized public reporting. Nor is the amount of cost 'incurred' for government contract accounting purposes determined by, or equal to, allowability maximums calculable under the FAR. The regulation does not dictate PRB benefit levels and costs contractors must incur. It simply and solely sets a ceiling limiting the PRB cost allowable and payable under flexibly-priced government contracts. …

The government myopically alleges that appellant should have 'assigned' more than required by the Plan to each of those years. However, if PRB costs are not incurred, there is no requirement to assign, much less fund, 'phantom' costs. There is no evidence or allegation that a major contractor such as NGC would be unable or otherwise fail to fund properly incurred, measured and assigned costs. NGC funds what it properly accrues and assigns. … The regulation must be interpreted in the context of and in conformance with basic accounting principles of incurrence, assignment and accrual. …

The government has failed to sustain its burden of proving that any of the disallowed amount was or will be amortized as part of the transition obligation and claimed during the post-transition years. Its argument is founded on theoretical constructs that have no factual

basis or evidentiary support here. In this case, the government's concerns were legitimate, albeit its legal and factual analysis was faulty.

(Emphasis in original.)

So sometimes government contract cost accounting can be complicated. This is one of those times. At the end of the day, Northrop Grumman spent millions of dollars on unallowable attorney fees, money that could have been used to fund IR&D projects or to attract scientists or engineers. The government took time and resources away from fighting overt contractor corruption in order to pursue one DCAA auditor’s legal theory, a theory that had been rejected by DCMA’s own Insurance and Pension experts. However, we need to keep in mind that the matter was complicated and, although the Board found the legal theory to be flawed, the situation was so complicated that it took two decisions over the course of more than three years to get to the answer.

Which may be appealed….