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Six years ago (in 2005) the FAR Councils published **significant revisions** to the "CAS Administration" portion of the FAR—specifically, FAR 30.6 and the related FAR 52.230 CAS solicitation provisions and contract clauses. The revisions were hated by industry. Promulgating comments from the time include the following summary of public input regarding the proposed rule—

One respondent stated that the proposed rule is unnecessarily complicated and does not address the major reasons that the current process does not work. Two respondents asserted the proposed rule is so detailed and prescriptive that CFAOs will be unable to exercise good business judgment and consider the unique aspects of each contractor's business environment in settling issues. Another respondent stated that the highly prescriptive nature of this regulation will impede the expeditious and fair resolution of CAS issues. The respondent stated that CFAOs will interpret the proposed rule as significantly decreasing the flexibility regularly exercised under the current regulation. … Four respondents commented that the cost-impact calculation should not include closed contracts or years with final negotiated overhead rates.

The response of the FAR Councils to the public comments/concerns was terse: "Nonconcur." The FAR Councils were going ahead with the rulemaking despite industry's grave concerns. Importantly, among those industry concerns were problems with the proposed approach to calculating "increased costs in the aggregate." As our readers will understand, that is a critical aspect of the cost impact analysis since, when a contractor makes voluntary (aka, "unilateral") changes to its cost accounting practices, the Government is prohibited (by statute) from paying "increased costs in the aggregate" as a result. The problem was that the term lacked a precise definition in the CAS regulations and the FAR Councils had made up their own definition—in brazen defiance of the CAS Board authorizing statute, which reserved the right to interpret CAS regulations *exclusively to the CAS Board*.

Six years of history has shown the prescience of industry's concerns. CAS administration issues remain among the most contentious and difficult to resolve of any issues between contractors and Government. Many—if not all—CAS-covered government contractors have a backlog of CAS issues that have lain unresolved for many years. In fact, the backlog of unresolved CAS issues has grown to such an alarming extent that, quite recently, the DOD initiated a special " **Cost Recovery Initiative** " to push their resolution.

Adding to the myriad problems inherent in resolving cost impacts is troubling, and wrong-headed, DCMA and DCAA guidance. The **DCMA guidance** was issued by the DOD

Directorate of Procurement and Acquisition Policy (DPAP) in 2002 and was immediately met by a firestorm of criticism from both industry and legal practitioners. Fortunately, then DPAP Director Deirdre Lee issued subsequent guidance that helped assuage the problems her Directorate had caused. According to the supplemental guidance, Contracting Officers were not permitted to cite to the original DPAP guidance memo as support for their positions; they were required to cite to the CAS regulations themselves. (We note that the DCAA website lists the 2002 DPAP memo under "open audit guidance" but fails to list DPAP's subsequent modification to it ….)

DCMA's problems have been exacerbated by largely unwarranted criticism with politicians such as Senator Claire McCaskill (who recently **said** in a hearing, "contracting officers lose objectivity because they get too friendly with the contractors they oversee and build connections with the companies as business partners, and therefore lighten up on tough independent supervision."). The criticism has resulted in an excessively risk-adverse culture where nearly every significant administrative contracting officer (ACO) decision has to be reviewed by a Board of Review—and often by multiple Review Boards. Any failure to rubber stamp a DCAA audit finding—no matter how incorrect it may be—is subject to a lengthy bureaucratic "dispute resolution process" that puts the ACO squarely in the cross-hairs of his or her headquarters. The only smart move at DCMA these days, with respect to controversy between DCAA and the contractor, is to delay or defer any decision that might engender criticism. Thus: the smartest action for a career ACO to take is no action.

DCAA's actions in the CAS administration process create even more problems than DCMA's inaction. Let's dig into this aspect a little bit.

DCAA's guidance to its auditors implementing the 2005 FAR Part 30 revisions was issued via MRD 05-PAC-041(R), dated June 6, 2005. That audit guidance is still the agency's official policy, and still listed under "open audit guidance" on the DCAA website. Looking at that audit guidance, one thing seems clear—the 2005 FAR revisions were driven by DCAA's view of the world. In support of that assertion, note the following comment in the MRD's Summary section—

The significant revisions to FAR Part 30 pertain to the process for determining and resolving the cost impact on CAS-covered contracts and subcontracts when a contractor makes a change to a cost accounting practice or fails to comply with CAS. Substantive changes have also been made to FAR Part 30 by adding definitions of pertinent terms and delineating the processes for administering cost accounting changes and noncompliances. The revised FAR Part 30 provides the process of calculating and resolving cost impacts. The 5-step process for calculating cost impacts provided in the audit guidance issued in February 2000, and incorporated in CAM 8-503, reflects the concept of calculating cost impacts promulgated by this revision to FAR Part 30.

In other words, DCAA’s “5-step process for calculating cost impacts”—issued in 2002—was *so attuned* to the FAR Council’s future “significant revisions”—issued in 2005—that *no significant revision* to DCAA’s audit procedures was required to implement the FAR procedural revisions in that complex area.

Without digging too deep into the hole, DCAA’s five-step process is summarized as follows:

1. Compute increased/decreased cost estimates and/or accumulations for all affected CAS-covered contracts and subcontracts.

2. Combine impacts by contract type (flexibly priced and fixed-price).

3. Net the impacts within each contract type together (including impacts to profit/fee/incentives) to determine increased or decreased costs paid by the Government for each contract type.

4. Determine the increased costs paid by the Government in the aggregate by combining across contract groups the increased/decreased costs paid by the Government for both contract groups, as determined in step 3.

5. Settle the impact.

As we've noted before, DCAA's audit guidance is problematic. Among the many problems is that it treats impacts from voluntary/unilateral changes the same as it treats impacts from noncompliances. It also has problems with the definition of "affected" CAS-covered contract and tells auditors to look at future impacts on contracts that haven't yet been awarded to the contractor, as well as to impacts of contracts that have been long completed and closed, when determining the cost impact of CAS administration issues on "affected" CAS-covered contracts.

In March 2006, the U.S. Court of Federal Claims dealt a body blow to the DCAA's audit guidance. Judge Allegra, writing for the Court, found that cost increases on one contract type could be reduced or offset by cost decreases to another contract type. The Court found that—

Notably, there is no hint in the preamble that this regulation requires a contractor to reimburse the government fully for increased costs under a cost reimbursement contract if the same CAS violation had the effect of decreasing costs in other fixed-price contracts. Such an interpretation of 48 C.F.R. § 9903.306(b), indeed, seemingly would violate the aggregation principle of 41 U.S.C. § 422(h), rendering the regulation suspect. *…* Fortunately, that is not a problem here, as defendant's interpretation of the regulations is – in a word – wrong. …

Based upon … the plain wording of the statute and FAR provisions at issue, defendant [the government] is incorrect in suggesting that decreased costs associated with other fixed-price contracts it had with Lockheed cannot have the effect of diminishing or even eliminating the cost increases associated with the noncompliance of the CAS in question. Were defendant correct, a contractor that used a computer only to service government contracts might still end up owing the government increased costs for a CAS violation, even if, rather than using that computer in a flexibly-priced contract as forecasted, the contractor instead used the computer entirely for other fixed-priced government contracts. This result, of course, would be anomalous and provide the government with a windfall. More importantly, it is precisely the result that Congress sought to avoid in admonishing that – "[i]n no case shall the Government recover costs greater than the increased cost . . . to the Government, in the aggregate, on the relevant contracts subject to the price adjustment." 41 U.S.C. § 422(h)…

(Ironically, the Judge used the DCAA's own audit guidance to support his decision.)

More recently, in June 2010, the U.S. Court of Appeals (Federal Circuit) **ruled** that DCAA's interpretation of what contracts were "affected" CAS-covered contacts was—in a word—wrong. As we reported at the time—

… the Appellate Court upheld the ASBCA's finding that a contract that has been repriced using the changed cost accounting practices should not be included in a contractor's cost impact analysis. Once the contract's estimated cost and/or price had been renegotiated to include the cost impact, it was no longer an "affected contract" and was properly excluded from the various cost impact analyses negotiated between the CFAO and the contractor.

Even more recently, in March 2011, the Armed Services Board of Contract Appeals (ASBCA) handed the Raytheon Company an important victory and, in the process, further eroded the government's problematic interpretations of the CAS administration process.

Here's a **summary** of the decision by the attorney who represented Raytheon, Paul Pompeo of the firm Arnold & Porter.

Here's a **link** to the actual ASBCA decision—ASBCA No. 56701 (which you won't find on the ASBCA site at this time).

A quick summary of the case: Raytheon changed its method for calculating the "actuarial value of assets" (AVA) for one of its pension plans. The result of this voluntary (or unilateral) change was to immediately decrease the amount of pension plan costs the company measured and recorded, and priced and billed. To be clear: pension costs decreased on *both* flexibly priced and fixed-price contracts.

Raytheon submitted a cost impact analysis (a "Gross Dollar Magnitude" or GDM analysis) that showed no increased cost to the Government because Raytheon set-off the cost decreases on FFP contracts against the (larger) cost decreases on its flexibly priced contracts. (Readers should note that cost decreases on FFP contract types are treated as "cost increases" to the government in the cost impact calculation.)

Naturally, DCAA had a problem with Raytheon's methodology.

As Mr. Pompeo wrote—

The Defense Contract Management Agency (DCMA) made a claim for over US$40 million plus interest from Raytheon—the amount by which the government calculated that the pension costs, incorporated into Raytheon's existing fixed-price contracts, exceeded the actual costs incurred under the new AVA method. The government excluded from its calculation, however, the over US$57 million by which its pension contribution costs would *decrease* on flexibly priced contracts. The government argued that actual pension costs would be recovered under flexibly priced contracts, thus, there should only be an adjustment to fixed-price contracts. The government further argued that Raytheon would have an opportunity to charge the same pension costs under the current fixed-price contracts on some future contracts.

So the government wanted Raytheon to fork over $40 million related to "increased costs" on the FFP contracts but it was fine keeping the $57 million in decreased costs—costs that Raytheon would *not* be billing to the government—on the flexibly priced contracts. DCAA justified its position because those decreased costs eventually would be billed on future contracts. (Note that position was consistent with the "problematic" audit guidance discussed above.)

Consistent with DCMA's risk-adverse culture that encouraged ACO's to "rubber-stamp" DCAA findings, Raytheon's Corporate Administrative Contracting Officer ("CACO") "adopted the findings and conclusions of the DCAA audit report, and demanded payment by Raytheon of $40,689,388 with compound interest from 27 January 2005 as a price adjustment for increased costs to the government, in the aggregate …."

Fortunately, the ASBCA found "no merit" to the government's arguments. It offset the cost increases on the FFP contracts with the cost decreases on the flexibly priced contracts, and found that Raytheon owed the government nothing. Moreover, it expressly dismissed the government's notion that future contracts should be taken into consideration in the contractor's cost impact analysis as being "entirely speculative," and said that "the price adjustment for consideration here is limited to the CAS-covered contracts in effect at the time the accounting change was made."

As Mr. Pompeo wrote—

For years, the question of what constitutes 'increased costs in the aggregate' under the CAS has escaped precise definition. There has also been uncertainty about what constitutes an 'affected contract' for purposes of contract price adjustments under the CAS. In addition, the government has been applying its newly created theory of impact on future fixed-price contracts in the determination of increased costs in the aggregate to other contractors. The ASBCA's holding establishes a straightforward rule that the determination of 'increased costs in the aggregate' means all CAS-covered contracts, but only those in existence at the time of the change in cost accounting practice—there cannot be consideration of future contracts that postdate the change.

For years, the government has consistently misinterpreted the CAS Board regulations regarding how to determine "increased costs in the aggregate" for purposes of ensuring that there are no overpayments on CAS-covered contracts when a contractor voluntarily changes its cost accounting practices. The government's misinterpretation has created chaos and led to a huge backlog of CAS-related issues and disputes. Fortunately, the Courts are helping to correct the misinterpretations and, generally, providing relatively clear guidance that CAS practitioners can follow.

Unfortunately, such corrections come at a very high price and take years to be issued. Meanwhile, DCAA and DCMA continue to add to the backlog of unresolved issues.