If you've been in this government contract cost accounting and compliance business long enough, you have come to realize that the regulations and the agency guidance aren't the end of the matter. Usually, it takes litigation to clarify what the regulations mean, and to determine if the agency guidance is (or is not) correct. Which is why we here at Apogee Consulting, Inc. spend a lot of time on the internet, looking at Court and Board decisions to see the judicial interpretations of the Federal Acquisition Regulation (FAR) and the Cost Accounting Standards (CAS). We routinely check out decisions at the Court of Appeals (Federal Circuit), the Court of Federal Claims, and the Boards of Contract Appeal, to see how they might impact our clients. And we post our (layperson's) thoughts about those decisions here in our blog.

This is one of those times.

Motions for summary judgment that are dismissed are not the final decisions of the judicial body. Normally that means there are issues of fact that need to be tried, and thus a final decision will be forthcoming in the future. But recently, the Judge Lettow of the Court of Federal Claims (CoFC) dismissed governmental motions for summary judgment and, in doing so, gave us a **thorough discussion** of the application of CAS 418.

Let's look at that decision, shall we?

Sikorsky Aircraft Corporation, long-time maker of helicopters, filed an appeal of an Administrative Contracting Officer's final decision alleging the company was in noncompliance with CAS 418. According to the DCAA and the ACO, Sikorsky owed about $80 million because it had improperly allocated the indirect costs of its "materiel overhead" pool in violation of the requirements of that Standard. The government filed several motions for summary judgment and, in the Court's words—

In essence, by the pending motions, the parties have asked the court to provide a general interpretative framework for the most relevant Cost Accounting Standard, 48 C.F.R. § 9904.418, and in particular Section 9904.418-50, to guide their preparation of the consolidated cases for trial and final disposition.

In crafting his decision, Judge Lettow needed to be mindful of several Federal Circuit Appellate Court decisions. The first decision was the infamous travesty of a judicial ruling (in our opinion, naturally) found in *Rumsfeld v. United Techs. Corp*., 315 F.3d 1361, 1369 (Fed. Cir. 2003). The second decision was a more recent Federal Circuit decision in *M. Maropakis Carpentry, Inc. v. United States*, 609 F.3d 1323 (Fed. Cir. 2010). As we'll point out, Judge Lettow took great pains to address those issues and to position his decision to survive appeal at that level of the judiciary.

The Judge's decision started with a review of the CAS Board history and put CAS 418 in that historical context. As Judge Lettow wrote—

Of particular interest to the pending motions in this case is CAS 418, which sets out how contractors may distribute indirect costs, such as overhead, among their contracts. Specifically, CAS 418 specifies accounting practices for 'the consistent determination of direct and indirect costs,' 'the accumulation of indirect costs . . . in indirect cost pools,' and 'the selection of allocation measures based on the beneficial or causal relationship between an indirect cost pool and cost objectives.'

Next, the Judge listed several "basic accounting concepts." These included the definitions of direct and indirect costs, as well as the definition of "cost allocation". For example, he wrote—

Indirect costs are apportioned according to an allocation method (also termed an allocation base, allocation basis, or cost driver), the selection of which is subject to detailed criteria. See *id*. § 9904.418-50. An allocation method, essentially, guides how an indirect cost is to be distributed among multiple cost objectives. For an indirect cost, an allocation method should be chosen based on the "causal or beneficial relationship," *id*. § 9904.418-40(c), between the indirect cost pool and the final cost objectives, *i.e*., the allocation base should distribute the indirect cost to final cost objectives in a manner accurately reflecting each cost objective's fair share of the indirect cost.

It what seems to us to be the Judge's great pains to give the Federal Circuit some clue as to the concept of cost allocation, the paragraph quoted above included a footnote, which read as follows—

A relatively straightforward example would arise if two families, one of two adults and a child, the other of just two adults, shared a $60 meal. The $60 could be allocated between the families by several allocation measures. If the child eats little, it would be sensible to select the number of adults as the allocation measure: $60 divided among four adults is $15 per adult, and there are two adults per family, so each family would bear $30 of the cost. If the child eats as much as

the adults, then a suitable allocation measure would be the number of persons: $60 divided among five persons is $12 per person, so the three-person family would bear $36 and the two-person family $24. See Ramji Balakrishnan et al., *Managerial Accounting* 88-90 (2009). If the child is a teenager who eats an extraordinary amount, a pounds-eaten allocation measure would be more appropriate. Assuming six pounds of food is eaten at the dinner, the food cost of $60 would be allocated at a rate of $10 per pound. If the four adults eat one pound each, and the child eats two pounds, the two-adult family, together eating 2 pounds, would bear $20 in costs, while the family with the child, together eating 4 pounds, would bear $40 in costs. For a more sophisticated example, see 48 C.F.R. § 9904.418-60(e).

Now that a context had been established, Judge Lettow turned to the merits of the case. The dispute concerned the proper cost allocation base to be used for Sikorsky's materiel overhead. The materiel overhead pool collected "costs of the purchasing department, of receiving and inspecting the materi[e]l, and of its storage and transportation." The Judge continued—

Prior to 1999, Sikorsky allocated its materiel overhead cost pool to contracts by a materiel cost base. 'In other words, Sikorsky allocated a portion of the materi[e]l overhead costs to each [g]overnment and commercial contract based on the cost of materi[el] associated with the contract.' ... According to Sikorsky, however, a materiel cost base distorted the relative costs of Sikorsky's contracts because it did not account for the indirect costs of government-furnished materiel ('GFM') — items like engines that the government purchases elsewhere and provides to Sikorsky at no cost for further assembly. ... 'As a result, under Sikorsky's pre-1999 accounting practice the value of GFM was not included in the materi[e]l cost base used to allocate the cost of materi[e]l overhead. Because GFM was excluded from the materi[e]l cost base, costs Sikorsky incurred when it received, handled, or inspected . . . GFM were under-allocated to [g]overnment contracts for which that work was performed.' Consequently, on January 1, 1999, Sikorsky began allocating its materiel overhead cost pool on a direct-labor-cost basis.

At the time Sikorsky made its allocation base change, the DCMA Corporate Administrative Contracting Officer (CACO) found that it created no material cost impact to CAS-covered contracts. However, "more than five years later," DCAA issued an audit report finding that Sikorsky's allocation base was in "potential noncompliance with CAS 418," which required Sikorsky to negotiate with a new CACO. According to Sikorsky, the matter was resolved by agreeing to a prospective change in allocation base. (The new allocation base was not specified in the decision.) But according to the government, that did not end the matter. As the Judge wrote—

Two years later, on April 5, 2007, Sikorsky's new CACO, Frank J. Colandro, relied on the same DCAA audit report issued in 2004 to submit a fresh notice to Sikorsky stating that its pre-2006 accounting practice potentially violated CAS 418. … Sikorsky protested that CACO Sherwood had approved its earlier practice and CACO Weisman had resolved the issues arising from the 2004 audit report. … Nevertheless, Mr. Colandro, on behalf of the Defense Contract Management Agency ('DCMA'), issued a contracting officer's final decision against Sikorsky. … The decision found that Sikorsky's pre-2006 accounting practice violated CAS 418, that the practice became material in 2003, and as a result Sikorsky had overcharged the government

respecting its contracts. *Id*. The decision ordered Sikorsky to pay the government $64 million in principal and $15 million in interest.

But before the Court could rule on the CAS matters before it, it first had to rule on the government's motion to dismiss Sikorsky's "protective, defensive claim" it had filed under a reasonable fear that its defenses wouldn't be allowed under the *Maropakis Doctrine*. The Maropakis Doctrine is another one of those *WTF? decisions* out of the Federal Circuit. Here's a **good summary** from McKenna Long & Aldridge.

In its Maropakis decision, as the attorneys at McKenna Long wrote, "the Federal Circuit held that a contractor's failure to present a certified claim for time extensions under its contract barred it from presenting any factual defenses to the government's liquidated damages claim." In other words, the contractor was prevented from asserting factual defenses against the government's claim, because it had failed to first submit a certified claim in accordance with the Contracts Disputes Act. Though Judge Newman emphatically dissented from the opinion, writing that it was "contrary to the purposes of the CDA, contrary to precedent, and an affront to the principles upon which these courts were founded," it stands as current precedent. The MLA attorneys summed-up the situation thusly—

Now, when challenging a Contracting Officer's final decision assessing liquidated damages, contractors must consider submitting a formal claim for recovery per the CDA prior to appealing the liquidated damages assessment, especially where the government sets-off the assessment against contract balance. Based upon the Federal Circuit's far-reaching decision, a contractor could be held to have waived its ability to present a factual defense to a liquidated damages assessment if, prior to its appeal, it fails to embed such a defense in a corresponding claim to modify/adjust the contract and/or recover the assessed amounts.

Consequently, Sikorsky filed a claim with the ACO that presented its affirmative defenses in its CAS 418 dispute, in order to preserve its right to raise them at trial. The ACO declined to issue any decision, because the matter was in litigation. Sikorsky appealed that deemed denial of its claim. So now the Court had two, related, appeals to adjudicate. Naturally, the government moved to dismiss Sikorsky's claim.

The whole course of action was ridiculous, but it was also the logical outcome of the Federal Circuit's *Maropakis* decision. Nice job there, Feds. Way to promote judicial economy.In any case, Judge Lettow was able to deal with the matter succinctly. First, he was able to distinguish between the current CAS 418 case and the *Maropakis* case. Second, he dismissed the matter based on simple logic. The Judge wrote—

Sikorsky need not be put to the Hobson's choice of preserving its affirmative defenses only through its original complaint or not at all. … On the assumption that *Maropakis* does not apply to Sikorsky's affirmative defenses, the court would continue to entertain Sikorsky's affirmative defenses as pled in Sikorsky's first complaint. Alternatively, if *Maropakis*' filing requirement does apply to Sikorsky's affirmative defenses, then this court manifestly has jurisdiction over Sikorsky's second complaint (and, again, also over Sikorsky's affirmative defenses). … If *Maropakis* applies to Sikorsky's affirmative defenses, the contracting officer's choice to decline issuing a final decision on Sikorsky's second set of claims would be incorrect: the claims would not have been already in litigation, so the contracting officer should have issued a final decision within 60 days or a reasonable time. … The officer's inaction thus would be deemed a denial, and appeal of that denial via the complaint in No. 10-741C would be jurisdictionally proper. … If *Maropakis* does not apply, then Sikorsky's second complaint would be merely redundant. Consequently, on these grounds, the court denies the government's motion to dismiss Sikorsky's complaint in No. 10-741C.

Having disposed of the pesky *Maropakis* decision, the Court next turned to the heart of the matter: compliance with CAS 418.

Judge Lettow wrote that "the central issue in this case is whether Sikorsky's allocation of its materiel overhead pool contravened the requirements of" CAS 418-50. The Judge wrote that there were two "mutually exclusive sets of requirements" in that section of the Standard. One set of requirements, found at 418-50(d), pertains to "indirect cost pools containing 'a material amount of the costs of management or supervision,'" whereas the second set of requirements (found at 418-50(e)) pertains to "such pools that 'do not include material amounts of the costs of management or supervision.'" (Emphasis added by the Judge.) Sikorsky and the government disagreed about which set of requirements should be applied to the evaluation of Sikorsky's materiel overhead pool. Resolution of that disagreement would go a long way towards resolving the appeal.

The Judge summarized the parties' positions thusly—

Sikorsky contends that the key to whether Subsection 418-50(d) or 418-50(e) applies to a pool is whether that pool includes 'a material amount of the costs of management or supervision.' … Thus, in Sikorsky's view, pools containing significant management or supervision costs, as a quantitative measure, are governed by Subsection 418-50(d), and those that do not are governed by Subsection 418-50(e). … In contrast, the government argues that the key to determining whether Subsection 418-50(d) or 418-50(e) applies to a pool turns on the phrase that follows 'material amounts of the costs of management or supervision,' *i.e., 'activities involving direct labor or direct materi[e]l costs.'*
… (emphasis added)…. The government avers that the CASB was not concerned with whether indirect pools contained management costs, but whether they collected costs of activities 'hav[ing] a direct and definitive relationship . . . [to] benefiting cost objectives.'

[The government's] interpretation of Subsections 418-50(d) and (e) serves as the textual touchstone for the government's chief argument: the government posits that Subsection 418-50(d) sets out the allocation rules for indirect cost pools collecting overhead costs, which costs have a tenuous relationship to cost objectives, while Subsection 418-50(e) sets out the allocation rules for indirect cost pools collecting costs of service centers, which are more directly attributable to cost objectives. … As the government would have it, pools containing management costs are entirely governed by another Cost Accounting Standard, *viz*., 48 C.F.R. § 9904.410 ('CAS 410'). … Therefore, reasons the government, because overhead pools fall strictly under Subsection 418-50(d), and because Sikorsky's materiel overhead pool is an overhead pool, the factual inquiries at trial should be limited to whether Sikorsky's pool complied with Subsection 418-50(d).

The Judge's reasoning, which we will quote extensively below, is clearly written to address concerns raised by the Federal Circuit in reversals of prior CAS decisions of the lower Court. For example, much is made of the "plain meaning" and use of "standard dictionary definitions" and significant effort is made to point out that no special accounting definitions are being applied. Keep in mind that the Federal Circuit has expressed suspicion regarding use of complex accounting terms and has clearly shown favor for such "Joe the Plumber" dictionary definitions. It seems to us that Judge Lettow was trying very hard to forestall those potential Appellate-level objections to his CAS analysis while he was setting-forth his interpretation of how CAS 418-50 operates. He wrote—

The plain language of Subsections 418-50(d) and 418-50(e) demarcates indirect cost pools based on two criteria: first, whether the pools contain significant management or supervision costs, and second, whether the activity being managed or supervised involves direct labor or direct materiel costs. Thus, Subsection 418-50(d) applies only to 'an indirect cost pool which includes [1] a material amount of the costs of management or supervision [2] of activities involving direct labor or direct materi[e]l costs.' … (bracketed numbers added). Conversely,

Subsection 418-50(e) applies to 'indirect cost pools [1] *that do not include* material amounts of the costs of management or supervision [2] of activities involving direct labor or direct materi[e]l costs.' … (bracketed numbers added) (emphasis added). In short, both types of indirect cost pools use the words 'activities involving direct labor or direct materi[e]l costs.' … Nonetheless, not all of the costs in an indirect cost pool may involve direct labor or direct materiel costs, and this circumstance may vary somewhat depending upon which Subsection is involved. Rather, the Subsections are primarily differentiated based upon whether the indirect cost pools involved contain significant amounts of management and supervision costs.

The regulation defines neither 'management' nor 'supervision.' Consequently, they 'will be interpreted as taking their ordinary, contemporary, common meaning.' *Perrin v. United States*, 444 U.S. 37, 42 (1979) …; see
Rumsfeld
, 315 F.3d at 1370 (applying 'standard dictionary definitions and other pertinent regulations' to determine the meaning of undefined CAS terms);
ATK Thiokol, Inc. v. United States
, 68 Fed. Cl. 612, 630-31 (2005). The word 'management' is a nominal of the verb 'manage,' which means '[t]o direct or control the use of; . . . [t]o exert control over; . . . [t]o direct or administer (the affairs of an organization, estate, household, or business).'
American Heritage Dictionary of the English Language 792
(New Coll. ed. 1976). Correlatively, the noun 'supervision' stems from the verb 'supervise,' which means '[t]o direct and inspect the performance of (workers or work); oversee; superintend.' Id. at 1292;
see also Random House College Dictionary
811, 1320 (rev. 1st ed. 1975);
Webster's Third New International Dictionary
1372, 2296 (16th ed. 1971). The words have no special meaning for accountants or auditors. See Erik Banks,
Palgrave Macmillan Dictionary of Finance, Investment and Banking
317-19 (2010) (no entry for 'management'); id. at 496-97 (no entry for 'supervision'); David O'Regan, Auditor's Dictionary 176-78, 250 (2004) ('management' defined as '[t]he process of directing, controlling, and planning in an organization' and 'supervision' defined as '[t]he oversight, review, and correction of a matter,' id. at 250);
Oxford Dictionary of Accounting
272-73, 404 (4th ed. 2010) (no entry for 'management' or 'supervision'); Joel G. Siegel & Jae K. Shim,
Dictionary of Accounting Terms
269-72, 429 (3d ed. 2000) (same). …

This plain language refutes the government's contention that the phrase 'management or supervision of activities involving direct labor or direct materi[e]l costs' denotes the concept of an overhead cost pool for Subsection 418-50(d) and the same language refers specifically to

service-center pools for Subsection 418-50(e). Had the CASB 'intended for [these subsections] to carry a specialized — and indeed, unusual — meaning . . . , [the CASB] would have said so expressly.' … ('Reluctance to working with the basic meaning of words in a normal manner undermines the legal process.'); *cf. Perry*, 47 F.3d at 1138 (There is 'no reason to believe the CASB would publish incomplete, and possibly misleading, illustrations.'). Section 418-50 does not mention overhead, service center, or other particular kinds of indirect cost pools. Instead, the language only refers to indirect cost pools generally, differentiating them insofar as they encompass 'management or supervision of activities involving direct labor or direct materi[e]l costs.'

[Emphasis added by us.]But the Judge wasn't finished (and so neither are we).

He continued—

The plain language of the triggering portions of Subsections 418-50(d) and (e) admit only one interpretation. Even so, the court must ensure that the interpretation is not manifestly mistaken in light of the regulatory context. See … (dismissing plain language arguments that 'would frustrate the undeniable purpose of [a CAS] provision,' id. at 1374). The stated purpose of this portion of the CAS is 'to provide for consistent determination of direct and indirect costs; to provide criteria for the *accumulation of indirect costs, including service center and overhead costs, in indirect cost pools* ; and, to provide guidance relating to the selection of allocation measures based on the beneficial or causal relationship between an indirect cost pool and cost objectives.' … (emphasis added). The second clause of the statement refers to both service center and overhead costs, but it does so in a way that suggests they should be grouped together, not separately. In this respect, the third clause states that all indirect cost pools should be allocated 'based on [their] beneficial or causal relationship [to] . . . cost objectives.'

Other portions of CAS 418 elaborate on these relationships. Section 418-40 explains that pools with significant management costs have a more attenuated causal relationship to cost objectives than do pools without significant management costs. 'If a material amount of the costs included in a cost pool are costs of management or supervision of activities involving direct labor or direct materi[e]l costs, resource consumption cannot be specifically identified with cost objectives.' … This is because, as Sikorsky observes, '[t]he costs of managing or supervising activities of employees whose own work involves various contracts are further removed from the benefiting contracts. As a result, indirect cost pools that include significant management or supervision costs 'cannot be allocated on measures of a specific beneficial or causal relationship.'' … Therefore, 'in that circumstance, a base [is] used which is

representative of the activity being managed or supervised," i.e., a base among the alternatives provided by Subsection 418-50(d).

Conversely, if a 'cost pool does not contain a material amount of the costs of management or supervision of activities involving direct labor or direct materi[e]l costs, resource consumption can be specifically identified with cost objectives.' … This is because the pool's activities are more directly associated with cost objectives. Consequently, the pool's costs can be allocated more precisely, i.e., '[t]he pooled cost [can] be allocated based on the specific identifiability of resource consumption with cost objectives . . . in accordance with the criteria set out in 9904.418-50(e).' Id. The regulation's illustrations bear out this analysis. See id. § 9904.418-60(e) (commenting that a weighted-square-foot basis for allocating occupancy costs 'adequately reflect[s] the proportional consumption of resources,' as required by Subsection 418-50(e)); id. § 9904.418-60(f) (noting that a dollars-of-materiel-issued basis for allocating the costs of a materiel-related overhead pool 'varies in proportion to the services rendered,' as required by Subsection 418-50(e)).

The Judge continued, reciting the history of the Standard's development and discussing both published and unpublished comments. We'll spare you that recital, though it's an excellent resource for those who may want to read it. The Judge summed-up as follows—

The plain language of 48 C.F.R. §§ 9904.418-50(d) and (e) divides indirect cost pools by inclusion, or not, of significant costs of management or supervision of activities related to direct labor or materiel costs. Pools containing such significant costs are governed by Subsection 418-50(d); pools without such costs are governed by Subsection 418-50(e). This interpretation is supported by the regulation's overall operation and purpose, and by the relevant regulatory history. Consequently, whether Sikorsky's materiel overhead pool falls under Subsection 418-50(d) or under Subsection 418-50(e) turns on whether the pool contained significant costs of management or supervision of direct-cost activities.

The government's motions were denied and the case will proceed to trial, where it will be determined whether or not Sikorsky's materiel overhead pool contained a "material" amount of the costs of management or supervision of the activities related to direct labor or materiel costs. Meanwhile, we practitioners of CAS and other related matters of government contract cost accounting compliance have an important resource to use, in order to better understand the operation of CAS 418.