We promise to stop beating this dead horse when DOD stops flogging it. Until then, we will continue to bring you news regarding this exemplar of misapplied Pentagon oversight.

For those less familiar with the situation to date, here are a couple of links to get you up to speed:

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**August 2009** – We opine that DCAA audit guidance is "troubling" and "contractors should immediately review their procedures associated with verifying dependent eligibility and shore them up as appropriate."

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**October 2010** – DCMA tells its Contracting Officers that HQ has agreed with DCAA that healthcare costs associated with ineligible dependents should be treated as "expressly unallowable" costs. So much for Contracting Officer "independent business judgment."

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**March 2011** – DCAA issues updated audit guidance to direct auditors that they should treat instances of contractors inadvertently claiming costs of ineligible dependents as a noncompliance with the requirements of Cost Accounting Standard (CAS) 405.

In the last update we concluded with a plea for the use of materiality and proportionality by government oversight officials. We wrote—

This insanity can be stopped, but only if adults step in to supervise the children. DCMA and DCAA are clearly caught up in 'much ado about nothing' and DOD leadership needs to realize the price that is being paid by its contractors, who will have to resolve these issues through the courts—since they see no other avenue available to them.

Well, here we are yet again—this time with a bit of a mixed message from DOD Leadership.

On February 17, 2012, Mr. Shay Assad, DOD Director of Pricing, issued a policy memo addressing this issue. Here's **a link** to the memo in question. Mr. Assad, who has **acted as intermediary** in related matters before, wrote—

… costs that were incurred for ineligible dependent health care are unallowable under FAR 31.201-3 because it would be unreasonable to reimburse costs incurred due to invalid claims made by employees, also the costs are in violation of the selected cost principle at 31.205-6(m). …

The Department of Defense will continue to disallow ineligible dependent health care benefit costs. To the extent that these costs were bid on fixed price sole source contracts, the costs were an inaccurate representation of the allowable cost. Contractors are encouraged to voluntarily refund the increase in price they received on their fixed price contracts as a result of including these unallowable costs in their proposals and hence, their negotiated prices. In some cases the ineligible health care benefit costs may have resulted in defectively priced contracts that were certified in accordance with TINA.

If you took the time to refresh you short-term memory with our three previous articles, you should already be feeling a stabbing feeling in the back of your skull. There may be some momentary nausea and disorientation. Ignore all that, get a hold of yourself, and let's evaluate DOD's current position, vis-à-vis some significant moved goalposts.

The first thing you ought to notice in the foregoing policy statement is that it is being asserted

that the costs in question should be unallowable "because it would be unreasonable to reimburse [them]."

You know what you do when you ass-ert something? Yeah, *that*.

Anyway, that assertion is *wrong*. First, "reasonableness" is a term of art, defined by the general (or "cornerstone") cost principle at FAR 31.201-3 ("Determining Reasonableness"). "Reasonableness" is an allowability evaluation criterion that is applied to costs claimed by a contractor. It does *not* apply to the decision-making of the DOD Leadership Team. (If it did apply, then … *wow*. So much language would have to be stricken from the regulations. But we digress.)

That clear misuse of the term was our first indication that this policy position was going to be as firm and tenable as Birnham Wood. (Yeah, it's a Shakespeare reference. Go look it up.) But that's not the end of the analysis, by any means. Let us continue:

We don't know—and *neither does the DOD Leadership*—whether or not it would be reasonable to permit contractors to include the costs of ineligible dependents in costs they propose, negotiate and, presumably, bill to the Pentagon. We don't know the amount of such costs, and how much it would cost to identify and segregate them from other claimed costs. Is DOD proposing that contractors each spend $10 million in order to save $50,000? We hope not, because that would be an *unreasonable* waste of contractor (and taxpayer) funds. To restate: it may be entirely reasonable to permit contractors to claim such costs—if the costs are immaterial in amount and the expense of identifying them and excluding them would exceed the amounts being claimed. We don't know the facts (*and neither does Mr. Assad*), and so it's clearly premature to assert that reimbursing the costs is (or would be) unreasonable.

Let's also remember that "reasonableness" has a fairly lengthy FAR definition which can be summed up as the comparison of the nature of the activity and the amount of costs in question to "that which would be incurred by a prudent person in the conduct of competitive business." Since this issue has been, by all reported accounts, a problem across the entire defense industry, we wonder whether it might be found to meet the FAR reasonableness test simply by existing in the first place. But that's for the Courts to decide….

We also want to smirk a bit at the assertion in the policy memo that the costs in question are "in violation of the selected cost principle at 31.205-6(m)." Maybe. Or maybe not. The policy memo summarizes the requirements of that piece of the Compensation Cost Principle in its first sentence (without—we note—an attribution, and before it subsequently misapplies the term "reasonable"). Putting aside the "reasonableness" focus for a minute (out of the kindness of our hearts), let's look at the implied assertion that ineligible dependent health care costs are unallowable because they are in violation of the contractor's established policy.

If that's the only basis for the cost disallowance, then the fix would be entirely straight-forward. Each contractor should simply amend its policy to permit formerly ineligible dependents to now be eligible for health care benefits. There. Problem solved. And you're welcome.

The thing is: that change is *already* in process. *And the Federal government is mandating it.*

What do we mean? Well, check out **the details** of President Obama's health care reform. You will note that one of the individual reforms is to mandate coverage of young adults on their parent's health care benefit plans until they are 26 years old. That's a fairly decent proportion of the formerly "ineligible" dependents right there. So the Pentagon's problem is already shrinking by executive direction (or public law, if you prefer).

But returning to the matter at hand, we are left with the unfortunate conclusion that this entire problem is all about contractors' policy. Rewrite the policy and what do the auditors have to base their assertions upon? Nada. Zip. Nothing.

But we are not done yet. Not by a long shot.

Look at the second paragraph in the policy memo. We'll repeat it for your convenience:

To the extent that these costs were bid on fixed price sole source contracts, the costs were an inaccurate representation of the allowable cost. Contractors are encouraged to voluntarily refund the increase in price they received on their fixed price contracts as a result of including these unallowable costs in their proposals and hence, their negotiated prices. In some cases the ineligible health care benefit costs may have resulted in defectively priced contracts that were certified in accordance with TINA.

Again, the assertion that the costs of the ineligible dependents "were an inaccurate representation of the allowable [health care] cost" is completely without support and absolutely up for debate. The policy memo is fairly clear that the health care costs in question are being bid, accounted-for, and billed as part of contractors' "fringe benefit" indirect cost pools. If that's so, then the question of fact that needs to be answered is whether the costs of the ineligible dependents were of sufficient magnitude to change the indirect cost rate being proposed (and accounted-for, and billed). If the costs were *de minimis* in amount and did not affect the indirect cost rate, then the costs were
*not*
inaccurately represented and the Government suffered no harm.

Further, we need to point out that FAR 31.102 undercuts the memo's assertions. It states (in part)—

However, application of cost principles to fixed-price contracts and subcontracts shall not be construed as a requirement to negotiate agreements on individual elements of cost in arriving at agreement on the total price. *The final price accepted by the parties reflects agreement only*

*on the total price.*

(Emphasis added.)

In other words, even if the fringe benefit costs proposed on Fixed Price contracts were inflated by the inclusion of the costs of ineligible dependents, once the price is negotiated *it no longer matters* .
The price was fair and reasonable, and that's sufficient for government contracting purposes.

Given the foregoing, it should be clear that there had better be a compelling business reason that would lead one to think it was appropriate to agree to a "voluntarily refund" of any price increase (assuming one even existed). We note the thinly veiled threat in the memo that contractors who fail to "voluntarily refund" their allegedly ill-gotten gains may be subject to allegations of defective pricing. That's pretty much a crock an error, in our view. We don't think that threat should play a factor in the decision-making surrounding this entire brouhaha.

The Truth-in-Negotiation Act (TINA) is a *disclosure* requirement, not a use requirement. In order to disclose, somebody has to *know*.
Logically, the contractor had to know it had ineligible dependents; it had to know the number of ineligible dependents; and it had to know how much health care costs were being increased by the ineligible dependents. And knowing, it had to fail to disclose. Given that most contractors didn't even know about the issue until DCAA decided to make an issue of it, that series of "had to knows" is very unlikely to have happened.

And we're not even going to go into the FAR 2.101 definition of "cost or pricing data" (another term of art) that states that such data is that which, "prudent buyers and sellers would reasonably expect to affect price negotiations significantly." We're not going to wonder whether anybody in their right minds would expect the cost of ineligible dependents to "significantly" affect price negotiations. Because if we did wonder about that, we'd be very skeptical.

So, having hopefully poked a few holes in the policy memo, you might reasonably think we'd be done. But first we have a few more shots to fire.

The Assad policy memo concludes with the following statement—

The Department will not pursue application of penalties under FAR 42.709 to these ineligible dependent health care benefit costs. However, it is our intention to amend the DFARS to make future ineligible dependent health care benefit costs expressly unallowable and thus subject to penalties.

We are pleased that the Pentagon policy-makers realized that it was going to be a bumpy road, fraught with peril, to try to assert that the costs were expressly unallowable. (See our previous comments on that issue in the links above.) Apparently somebody read the case law and realized it was going to be a loser.

But the fact that Mr. Assad's organization feels so strongly about this issue that it wants to amend the DFARS to bolster its position is just … *puzzling*. It never was that big of a deal and, as the memo itself acknowledges, "contractors, in large measure, have already corrected the problem and they are now not including the costs … in their claimed and estimated indirect rates." So, problem solved—but apparently that's just not good enough for the folks at the DOD. They seemingly feel the burning need to put a stake in the heart of this issue so that it can never rise again.

In our view, this has always been "much ado about nothing" and we are sad that the DOD policy-makers can't move on to something more important, like **contractor defined-benefit pension costs**. Like a dog with a bone, they keep worrying and worrying at it.

Maybe they should just bury this particular bone in the ground for a while. We're quite sure there are more meaty issues around to deal with.