Recently the ASBCA ruled on Exelis’ appeal of a Contracting Officer Final Decision (COFD) and government demand for $3.8 million, based on Excelis’ alleged noncompliance with the requirements of CAS 404. Judge D'Alessandris, writing for the Board, partially sustained the appeal and partially dismissed it.

According to the decision, Exelis (and its predecessor entity, ITT Corporation) leased the Summit Park Building in Fort Wayne, Indiana. Exelis, as many readers may know, was acquired last year by Harris Corporation. According to news reports , Harris has already closed the facility that may have formed the basis of this dispute.

Anyway, ITT Corporation, or Exelis, or Harris, treated its facility lease as an operating lease. In 2007, during it audit of Exelis’ FY 2004 proposal to establish final billing rates (aka incurred cost submission), DCAA questioned the lease costs, asserting that “the building lease was a capital lease, and that Exelis could only include building depreciation in its indirect cost pool rather than the entire lease cost.” Questions and discussions between the contracting parties ensued, and in June, 2015, the contracting officer issued the COFD, finding that Exelis failed to comply with the FAR cost principle at 31.205-11(m) as well as the requirements of CAS 404. “The final decision found that Exelis improperly accounted for the Summit Park Building lease as an operating lease when it should have been treated as a capital lease because the present value of the lease payments, at the inception of the lease, was greater than 90 percent of the fair market value of the building.” Because the CAS noncompliance opened up fixed price contracts to price adjustment—which led to a greater damage quantum—the government used the CAS noncompliance cost impact method to calculate its damages, which extended back to 2003.

Yes, the government asserted 12 years’ of damages.

Yes, the government waited eight years to assert its damages. (We don’t know when or if the Contract Disputes Act Statute of Limitations will be asserted as an affirmative defense. But in our non-attorney viewpoint, it should be.)

Because the government asserted 12 years' of damages and because it waited eight years to assert its claim, the quantum included $806,000 of compound interest. Had the government asserted its claim earlier, the interest amount would have been significantly decreased.

Because the government asserted its claim in the form of a CAS noncompliance, it was able to calculate damages on firm-fixed priced contracts. (This accounted for nearly 85 percent of the damages before interest.) Had the government asserted its claim solely in the form of a violation of the applicable FAR cost principle (i.e., as an unallowable cost), the amount of its claim would have been not more than $429,459 before interest.

Judge D'Alessandris dismissed the government's CAS noncompliance case, finding that "by its terms" CAS 404 "applies only to 'tangible capital assets' and does not apply to a lease because a lease is an intangible asset." Thus, "at most, the mischaracterization of a capital lease as an operating lease would create a FAR allowability issue."

Although the Judge found the government's claim to be overstated because of its flawed damage calculation methodology, he did not dismiss the case entirely. The parties will have a chance to brief and to argue about the FAR-based damages. That being said, the government's case loses a lot of momentum since it has been whittled down by some 85 percent—at a minimum. The government will need to calculate its damages in an entirely new way, since its CAS noncompliance argument failed.

And how will those FAR-based damages be calculated?

Providing a hint of the required methodology, the Judge quoted Darrell Oyer: “"The rule is that any capital lease costs in excess of the prescribed depreciation charges are unallowable." Thus, the government will have to calculate the difference between Exelis' claimed facility lease expenses, year by year, and the amount of depreciation that Exelis should have claimed, had it properly claimed depreciation only.

But that’s not the end of the matter.

The unallowable difference needs to be input into Exelis’ model for calculating its indirect rates.(Many contractors use the DCAA ICE Model, but they were not required to do so until 2011.) The delta difference needs to be input into Exelis’ model, reducing claimed allowable lease expense for each year. Then the resulting indirect rates need to be recalculated, and then the rates need to be reapplied to each of Exelis’ contracts. The aggregated amount by which contract costs are reduced as the result of that exercise is the measurement of the government’s damages, before interest. We strongly suspect that value will be significantly less than $429,459. It might even be immaterial in amount.

Some might argue that Exelis should be subject to the penalty provisions of FAR 42.709-1. The FAR provides that if a contractor claims an indirect cost that is expressly unallowable under a cost principle in the FAR, or an executive agency supplement to the FAR, the contractor must pay a penalty equal to (a) The amount of the disallowed costs allocated to contracts that are subject to this section for which an indirect cost proposal has been submitted, plus (b) interest on the paid portion, if any, of the disallowance. We don’t think so.

First, the penalty provisions only apply to cost-type contracts, which are about 15 percent of the Exelis’ total activity. Second, there is a real question as to whether the claimed cost in question were “expressly unallowable” as that term is defined. (We wrote about that topic here .) Expressly unallowable costs are a small subset of unallowable costs. Given that the parties here took some eight years to conclude the costs were unallowable, we strongly suspect it’s going to be difficult to convince a Judge that the costs in question were expressly unallowable.

In any case, Exelis, like Raytheon, disputed a COFD with which it disagreed. That COFD was based on an audit report prepared by DCAA, an audit report whose methodology was so flawed Exelis was able to have the vast majority of claimed damages tossed without a trial on the merits.

We are forced to wonder: if the DCAA auditors had been in less of a rush to question millions of dollars of costs, if the auditors and Supervisory Auditors had simply stuck to the FAR instead of zooming into CAS noncompliance land, would the resulting quantum have been worth litigating? Maybe the contracting officer and Exelis could have negotiated a settlement acceptable to both sides? We will never know.

In any case, let's note that any reports regarding DCAA questioned cost sustention rates need to be modified. In addition to noting when questioned costs are not sustained by the contracting officer, the taxpayers also need to know when sustained questioned costs are laughed out of court.