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FEATURE COMMENT: The Proposed Rule On Cost Accounting Standards Administration—"There You Go Again"

The proposed changes to Federal Acquisition Regulation Part 30, published on July 3, 2003 (see 68 Fed. Reg. 40104; 45 GC ¶ 272), incorporate many controversial Defense Contract Audit Agency (DCAA) positions that were widely criticized and ultimately abandoned by the Cost Accounting Standards Board (CASB) in its aborted rulemaking effort to revise the definition of a cost accounting practice change and redefine the cost impact process. The CASB's contentious rulemaking effort lasted seven years, including an April 1993 Staff Discussion Paper (see 58 Fed. Reg. 18428, 35 GC ¶ 256), an April 1995 advance notice of proposed rulemaking (see 60 Fed. Reg. 20252, 37 GC ¶ 236), a September 1996 notice of proposed rulemaking (see 61 Fed. Reg. 49196, 38 GC ¶ 451), a July 1997 supplemental notice of proposed rulemaking (see 62 Fed. Reg. 37654, 39 GC ¶ 344), and an August 1999 second supplemental notice of proposed rulemaking (see 64 Fed. Reg. 45700; 41 GC ¶ 392 and 41 GC ¶ 402). The CASB then essentially abandoned the effort, making only modest changes to the CAS program requirements to clarify the applicable interest rate and describe the findings the administrative contracting officer must make before making any of the three types of adjustments contemplated by the various CAS clauses; and adding a new section 9903.20-8 to establish that contract price and cost adjustments are not applicable to compliant cost accounting practice changes directly associated with external restructuring activities that are subject to and meet the requirements of 10 USCA § 2325 (see 65 Fed. Reg. 37469, 42 GC ¶ 247).

When the proposed rule for FAR Part 30 was initially published on April 18, 2000 (see 65 Fed.

Reg. 20854; 42 GC ¶ 157), it was viewed as a welcome improvement over the CASB's then-pending second supplemental notice of proposed rulemaking. However, instead of improving the proposed rule in response to public comments, the current revised proposal is much longer, more poorly drafted, and incorporates even more aggressive DCAA positions than the initial proposal.

Helpfully, the revised proposal incorporates the CASB's June 2000 final rule excluding cost accounting practice changes related to external restructuring from the cost impact process, codifies the existing practice of preparing contract pricing proposals using changed cost accounting practices, and acknowledges that some contracts may contain both fixed price and flexibly priced line items—just as some contracts may contain both CAS-covered and non-CAS-covered line items. This **FEATURE COMMENT** analyzes some of the more problematic aspects of the revised proposal, however, including its (1) interpretation of increased costs to the Government; (2) limitation on the use of offsets between fixed price and flexibly priced contracts, and other restrictions on the contracting parties' existing flexibility to resolve cost impacts; (3) inclusion of closed contracts in the cost impact process; and (4) failure to correct deficiencies in the existing rule for desirable changes.

Increased Costs—For unilateral changes, formerly called voluntary changes, proposed FAR 30.604(h)(4)(i)(A) defines—by way of an algebraic formula—decreased cost allocations on fixed-price contracts and subcontracts as increased costs to the Government. Similarly, for noncompliances, which under proposed FAR 30.001 include a contractor's failure to both comply with applicable CAS and consistently follow its disclosed and established cost accounting practices, proposed FAR 30.605(h)(5)(i) defines decreased costs on fixed-price contracts and subcontracts as increased costs to the Government. The proposal's interpretation of increased costs, and more particularly its failure to distinguish between the increased costs that result from unilateral changes and those that result from noncompliances, is inconsistent with existing CASB regulations. Moreover, the

statutory authority for defining increased costs is specifically and exclusively vested in the CASB.

The CASB interpretation of “increased costs” at 48 CFR § 9903.306 draws a distinction between contract adjustments required for unilateral changes and noncompliances. Paragraph (a) of the interpretation, which applies to both unilateral changes and noncompliances, defines “increased costs” as the actual costs paid by the Government as a result of the change or noncompliance. Paragraph (b), on the other hand, applies only to noncompliances, and provides in pertinent part that:

If the contractor under any fixed price contract, including a firm fixed price contract, *fails during contract performance to follow his cost accounting practices or to comply with applicable Cost Accounting Standards*, increased costs are measured by the difference between the contract price agreed to and the contract price that would have been agreed to had the contractor proposed in accordance with the cost accounting practices used during contract performance. [Emphasis added]

The interpretation was promulgated by the original CASB, pursuant to its authority under the Defense Production Act Amendments of 1970, and in 1992 was republished without change by the current CASB. Section 103(h)(1) of the 1970 amendments authorized the original CASB to promulgate regulations that, among other things, provide for “a contract price adjustment, with interest, for any increased costs paid to the defense contractor by the United States because of the defense contractor’s *failure to comply with duly promulgated cost-accounting standards or to follow consistently his disclosed cost-accounting practices* in pricing contract proposals and in accumulating and reporting contract performance cost data” (emphasis added). Faithful to its statutory charge, in interpreting the term “increased costs paid,” the original CASB maintained the important distinction between contract adjustments required for *voluntary changes* and those required for CAS *noncompliances* and *failures to follow disclosed practices*.

The statutory language underlying the existing interpretation changed with the Office of Federal Procurement Policy (OFPP) Act Amendments of 1988. Section 26(g) of the OFPP Act Amendments directs the CASB to promulgate regulations that, among other things, provide for “a contract price adjustment, with interest, for any increased costs paid

to such contractor or subcontractor by the United States by reason of a change in the contractor’s or subcontractor’s cost accounting practices or by reason of a failure by the contractor or subcontractor to comply with applicable cost accounting standards.” See 41 USCA § 422(h)(1)(B). The legislative history of the 1988 amendments confirms that this change in the statutory language was a conscious one. As Senate Report No. 100-424 explains:

An issue brought to the Committee’s attention by industry is that the application of a CAS Board interpretation regarding the effect of contractor initiated changes in accounting systems may result in an inequity to the government or the contractor, when such accounting changes have the effect of reducing costs allocated to firm fixed-price contracts. *While the Committee does not express any view on the merits of this issue*, it fully anticipates the new CAS Board will analyze the circumstances under which such reduced cost allocations may or may not give rise to possible fiscal damage to the government and make any changes in existing rules or interpretations deemed appropriate as a result of the analysis. [Emphasis added]

Thus, while giving the CASB the statutory authority to include voluntary changes under the regulatory interpretation at 9903.306(b), Congress expressly took no position on whether such a change was appropriate. However, Congress clearly intended for the CASB—and not the procuring agencies—to define the term “increased costs.” For example, 41 USCA § 422(h)(3) provides that:

Any contract price adjustment undertaken pursuant to paragraph (1)(B) shall be made, where applicable, on relevant contracts between the United States and the contractor that are subject to the cost accounting standards so as to protect the United States from payment, in the aggregate, of increased costs (*as defined by the Board*). In no case shall the Government recover costs greater than the increased cost (*as defined by the Board*) to the Government, in the aggregate, on the relevant contracts subject to the price adjustment, unless the contractor made a change in its cost accounting practices of which it was aware or should have been aware at the time of the price negotiation and which it failed to disclose to the Government. [Emphasis added]

Nor do the existing CAS clauses at 48 C.F.R. § 9903.201-4(a)(2), (c)(2), and (e)(2) give the Government the right to adjust the price of firm fixed price contracts as a result of a unilateral change. The clauses promulgated by the CASB, just as the interpretation of increased costs, contemplate distinctly different types of contract adjustments for unilateral changes and noncompliances. For noncompliances, the clauses expressly require the contractor to agree to a price adjustment and mandate the recovery of increased costs paid by the U.S. Subparagraph (a)(5) of the CAS clause requires the contractor to agree to “an adjustment of the contract price or cost allowance...if the Contractor or a subcontractor fails to comply with an applicable Cost Accounting Standard, or to follow any cost accounting practice consistently and such failure results in any increased costs paid by the United States.” It also expressly stipulates that the “adjustment shall provide for recovery of the increased costs to the United States.”

By contrast, subparagraph (a)(4)(ii) of the CAS clause, which applies to unilateral changes, requires only that the contractor “negotiate with the Contracting Officer to determine the terms and conditions under which a change may be made to a cost accounting practice,” with the proviso that “no agreement may be made under this provision that will increase costs paid by the United States.” Accordingly, for unilateral changes, the clause does not require a price adjustment, or for that matter, any particular type of adjustment. Moreover, there is no requirement under subparagraph (a)(4)(ii), as there is under subparagraph (a)(5), for the “recovery of increased costs paid by the United States.” The discretionary nature of the agreement contemplated by subparagraph (a)(4)(ii) is supported by the following interpretation at 48 CFR § 9903.306(d):

The contractor and the contracting officer *may* enter into an agreement as contemplated by subdivision (a)(4)(ii) of the Cost Accounting Standards clause at § 9903.201-4(a), covering a change in practice proposed by the Government or the contractor for all of the contractor’s contracts for which the contracting officer is responsible, provided that the agreement does not permit any increase in the cost paid by the Government. [Emphasis added]

The existing CASB regulations also make clear that a unilateral change is significantly different from a contractor’s failure to follow its disclosed or

established practices. CAS 401 is the Standard that would be implicated by a failure to follow consistently a contractor’s disclosed or established cost accounting practices. In applying the fundamental requirements of CAS 401, the CASB regulations make two important points. First, compliance with CAS 401.40(a) is determined on the contract award date or, if the contractor submits cost or pricing data, the date of final agreement on price. See 48 CFR § 9904.401-50(b). Second, a contractor may change its accounting practices without violating CAS 401. CAS 401.50(b) provides that “[n]otwithstanding 9904.401-40(b), changes in established cost accounting practices during contract performance may be made in accordance with part 99.” This provision was added during the initial promulgation of CAS 401 to address the seeming “inconsistency between the requirements of the standard and the ability to make changes to established cost accounting practices.” See Preamble A. As the original CAS Board stated:

The Board intends that compliance with respect to proposals shall be determined as of the award date of the contract or as of the date of final agreement on price if the contractor has submitted cost or pricing data pursuant to [the Truth in Negotiations Act]. Modifications of established cost accounting practices for accumulating and reporting costs are permitted by other regulations of the Cost Accounting Standards Board without causing a violation of this standard. The Board has modified the standard to express these intentions.

DCAA’s Contract Audit Manual recognizes that the CASB’s interpretation of increased costs under fixed price contracts applies only to noncompliances, but asserts that it “should apply to all price adjustments involving FFP contracts.” DCAM ¶ 8-503.2. The proposed rule simply adopts DCAA’s position, notwithstanding the absence of any statutory authority.

Offsets—The revised proposal eliminates the term “offset,” ostensibly to “avoid potential confusion,” but states that it “includes the effect of offsets in the cost impact calculation process by separating the calculation of the cost impact from the resolution of the cost impact.” See 68 Fed. Reg. at 40104. In fact, proposed FAR 30.604(h)(4)(iv) and 30.605(h)(8) and (9) effectively *preclude* the use of offsets between fixed price and flexibly priced contracts.

As noted above, 41 USCA § 422(h)(3) expressly prohibits the Government from recovering more

than the increased cost to the Government, in the aggregate, on the contracts subject to adjustment. In certain circumstances, such as when a unilateral change or noncompliance results in the shift of costs from fixed-price contracts and subcontracts to flexibly-priced contracts and subcontracts, barring offsets between these contract types will result in the Government recovering *more* than its aggregate increased costs in contravention of the statute.

For example, assume that a contractor has two \$50 million CAS-covered contracts, one firm fixed price (FFP) and the other cost reimbursement, each requiring that the contractor supply 500,000 units. The Government is therefore buying 1 million units for \$100 million. Assume further that as a result of the contractor’s unilateral change in cost accounting practices, the estimated cost to complete the FFP contract decreased by \$10 million, and the estimated cost to complete the cost reimbursement contract increased by \$10 million. Finally, assume that had the cost impact of the unilateral change been known at the time the two contracts were negotiated, the negotiated profit on the FFP contract would have been \$1 million less and the negotiated

fixed fee on the cost reimbursement contract would have been \$1 million more.

If no adjustments were made as a result of the change, the Government would pay \$50 million on the FFP contract and reimburse costs of \$60 million on the cost reimbursement contract, resulting in the payment of increased costs, in the aggregate, of \$10 million. That is because the Government would pay \$60 million for the million units instead of the \$50 million it originally expected to pay. Ignoring for the moment the absence of any contractual authority to require a downward price adjustment on the FFP contract, if both contracts were subject to individual contract adjustments (i.e., if the price of the FFP contract were adjusted downward by \$10 million and the additional costs of \$10 million on the cost reimbursement contract were disallowed), the Government would pay only \$40 million for the million units. Making individual contract adjustments under these circumstances would therefore result in a windfall to the Government of \$10 million. Yet, as shown in chart below, that is precisely the result that obtains from the calculation required by proposed FAR 30.604(h)(4)(iv).

Example Calculation of Aggregate Increased Costs to the Government When Unilateral Change Shifts Costs from Fixed Price to Flexibly Priced Contracts		
Step 1: Comparing the Pre- and Post-Change Estimated Cost To Complete		
Affected Contract Type	Estimated Cost To Complete Using Current Practice	Estimated Cost to Complete Using changed Practice
Fixed Price	\$ 50,000,000	\$ 40,000,000
Flexibly Priced	\$ 50,000,000	\$ 60,000,000
TOTAL	\$100,000,000	\$100,000,000
Step 2: Calculating the Aggregate Increased or Decreased Cost to the Government		
Component	Increased or Decreased Cost to the Government	
CAS-Covered Fixed-Price Contracts and Subcontracts	\$ 10,000,000	
CAS-Covered Flexibly Priced Contracts and Subcontracts	\$ 10,000,000	
Net Affect on Associated Incentives, Fees, and Profits	\$ 0	
AGGREGATE INCREASED COSTS	\$ 20,000,000	
Step 3: Resolving the Cost Impact		
Affected Contract Type	Increased/(Decreased) Cost Allocation	Actions To Be Taken To Preclude Increased Costs
Fixed Price	(\$ 10,000,000)	Downward price adjustment of \$10,000,000
Flexibly Priced	\$ 10,000,000	Disallow costs of \$10,000,000
Net Result	\$ 0	Contractor out-of-pocket loss and windfall to Government of \$10,000,000

Although the prefatory comments to the proposed rule state that the rule includes the effect of offsets by separating the calculation of the cost impact from the resolution of the cost impact, proposed FAR 30.606(d) permits the cognizant federal agency official (CFAO) to use an alternative method instead of adjusting contracts to resolve the cost impact only when the Government will not pay more in the aggregate than it would have paid if the CFAO did not use the alternative method. The prefatory comments expand on this point by stating that:

In an ideal world, the CFAO would adjust all contracts so that each and every dollar of the cost impact is perfectly re-allocated to each and every affected contract. However, the Councils recognize that, in many instances, adjusting all contracts is not practical or feasible. The proposed rule, therefore, provides the CFAO the flexibility to resolve the cost impact using methods other than adjusting every contract, provided the Government will not pay more, in the aggregate, than would be paid if the CFAO had adjusted all the contracts.

See 68 Fed. Reg. at 40104. The proper baseline for comparison is whether the Government would pay more, in the aggregate, than it would have paid in the absence of the unilateral change or noncompliance, not whether the Government will pay more, in the aggregate, than it would have paid if individual contracts were adjusted or the offset process were not used.

Inexplicably, proposed FAR 30.606(a)(3) contains a number of other restrictions that will further limit the contracting parties' existing flexibility to resolve cost impacts. Among other things, the proposal would preclude the CFAO from combining the cost impacts of (1) changes implemented in different fiscal years, (2) changes and noncompliances, (3) two or more noncompliances, or (4) different categories of compliant changes. No explanation, much less justification, is provided for these restrictions, and they do not appear necessary to protect the Government from paying increased costs as defined by the CASB.

Accordingly, because the proposed rule permits, if not requires, the CFAO to recover costs greater than the increased costs to the Government, it contravenes the plain language of 41 USCA § 422(h)(3).

Closed Contracts—Proposed FAR 30.604(h)(1) and 30.605(h)(1) would require that cost impact calculations for both unilateral changes and

noncompliances “[i]nclude all affected CAS-covered contracts and subcontracts regardless of their status (i.e., open or closed) or the fiscal year(s) in which the costs were incurred (i.e., whether or not the final indirect cost rates have been established).” This is a change from the rule as originally proposed, and reflects the adoption of another DCAA position with which contractors have long disagreed. Because unilateral changes are generally applied only prospectively, the proposal would most significantly affect the cost impact process for noncompliances.

Absent a contract provision such as a reopener clause, closed contracts and established final indirect cost rates are generally considered not subject to change. Final indirect cost rates are, by definition, “established and agreed upon by the Government and the contractor as not subject to change.” See FAR 2.101. That is why, for example, open CAS noncompliances frequently delay the establishment of final indirect rates and contract close-out. It is also why the Allowable Cost and Payment clause at FAR 52.216-7 requires the contractor, as a condition of receiving final payment, to give the Government an assignment of refunds, rebates, and credits so that the contractor's obligation will survive final payment. For example, the ASBCA in *NI Industries, Inc.*, ASBCA 34943, 92-1 BCA ¶ 24631, 34 GC ¶ 2, held that a contractor that received a reversion of previously reimbursed pension assets after terminating its pension plan was required to give the Government a credit for the portion of the surplus allocable to open cost type contracts and closed cost type contracts for which the contractor had executed an assignment of refunds, rebates and credits, but *not* for the portion allocable to closed cost type contracts for which no assignment had been made.

The proposed rule ignores these principles of finality. None of the CAS clauses contains any provision stating that it survives final payment. Moreover, to the extent a noncompliance extended for more than six years, any Government claim would be barred by the Contract Disputes Act's statute of limitations. See 41 USCA § 605(a).

Desirable Changes—As it has, since it was amended on March 10, 1978, the CAS clause permits the negotiation of an equitable adjustment when the contractor makes a unilateral change that the contracting officer determines to be desirable and not detrimental to the Government's interests. The advantage of the provision is that, unlike other

unilateral changes, the Government may agree to pay increased costs that result from desirable changes. The principal disadvantage, however, is that it is discretionary, and, consequently, rarely ever used.

The proposed rule does not resolve the problem with the current desirable change rule and, if anything, makes it worse. The proposal would still leave the Contracting Officer considerable discretion in declining to determine that a change is desirable, and unduly emphasizes cost to the Government. Proposed FAR 30.603-2(b)(3) lists three factors to consider in determining if a change is desirable, two of which have to do with the financial impact on the Government. If desirable changes are limited to those that result in decreased costs to the Government, one hardly needs a provision permitting the Government to pay increased costs.

The proposal also fails to specify a time when the CFAO must determine whether the change will be desirable, saying only that “the CFAO shall promptly evaluate the contractor’s request and, as soon as practical, notify the contractor in writing whether the change is a desirable change or the request is denied.” See proposed FAR 30.604(c). The rule would be better if the CFAO were required to make a determination that a change is desirable if certain specified conditions are met, and if the determination were required to be made within a stated period of time.

In summary, while the FAR Councils unquestionably have the authority to promulgate regulations governing the administration of CAS, only the CASB has the authority to define “increased costs.” Moreover, neither the CASB nor the FAR Councils may lawfully promulgate regulations requiring the recovery of more than the increased costs (as defined by the CASB), in the aggregate, that result from the change or noncompliance. The proposed rule carries significant financial ramifications for contractors and the Government. Interested parties will have the opportunity to question the drafters at a public meeting on August 5, 2003. Additionally, written comments may be submitted until September 2, 2003. The ensuing debate should, at a minimum, adhere to the statutory limits on the Government’s recovery to its aggregate “increased costs” and to the fundamental principle that the contracting parties—not federal regulators—are in the best position to resolve unilateral changes and

noncompliances in a manner that is both equitable and protects the Government’s interests.



This FEATURE COMMENT was written for THE GOVERNMENT CONTRACTOR by Karen L. Manos. Ms. Manos is a partner in the Washington, DC office of the law firm of Howrey Simon Arnold & White, LLP, a member of THE GOVERNMENT CONTRACTOR Advisory Board, Co-Chair of the ABA Section of Public Contract Law’s Accounting, Cost & Pricing Committee, and Vice-Chair of the National Defense Industrial Association’s Contract Finance Committee. “There you go again” is a line that presidential candidate Ronald Reagan used with great effect during his 1980 debate with President Jimmy Carter.