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DCAA RESPONDS TO THE JF TAYLOR AND METRON CASES

(Editor's Note. DCAA's audits of executive compensation results in the highest amount of questioned costs the agency generates. We have reported on two recent appeals to the ASBCA (JW Taylor case in the Q112 issue of the GCA DIGEST and the Metron case in the 3Q12 issue) that severely criticized DCAA's approach to evaluating contractors' executive compensation where one concluded their approach was "fatally flawed." Since the decisions were issued around three years ago, we have not found any changes in how DCAA conducts these audits and surprisingly, found no comments or guidance from DCAA addressing the decisions. DCAA has finally issued a response to the two ASBCA cases which one commentator has characterized as "canned." We do not believe that DCAA's response adequately addresses most of the points make by the Board in the JF Taylor case and DCAA makes no attempt to respond to the findings in the Meteon case. Nonetheless, we thought it would be interesting to summarize their 10 page response where we briefly review the cases, identify their responses to specific findings in the cases and we insert a few comments of our own.)

Summary Findings of the Two Cases

JF Taylor

During its audits of JF Taylor's (we will refer to it as JF) incurred cost proposals (ICPs) for the periods 2002-2005 DCAA's Mid-Atlantic compensation team conducted an executive compensation review for each year and concluded that excess compensation allocable to all relevant cost reimbursable contracts had been overcharged through its provisional billing rates for the four years. The methodology used by DCAA was typical of its approach where it decides what positions it will evaluate, selects at least three surveys that are comparable to the company's size and other relevant factors, escalates the survey data to the mid-point of the contractor's fiscal year, finds the median value of each survey, obtains a "market consensus" of the surveys by taking the average of the median values usually using the 50 percentile amounts, applies a 10 percent "range of reasonableness" (ROR) factor to the consensus data, makes any adjustments needed (e.g. offset for any under market fringe benefits), compares the results with claimed compensation of the contractor and questions the difference. JW Taylor presented several challenges, some of which DCAA accepted resulting in DCAA questioning a total of $859K of executive compensation over four years.

- **Appeals Board Decision**

The following is based on arguments put forth by JF's expert, Jimmy Jackson. Before we summarize his specific points, Mr. Jackson's overall opinion of DCAA's methodology is that "while it has the look of an objective mathematical model for determining unallowable compensation there is no substance to this scientific veneer. Instead there are fundamental flaws in DCAA's methodology and in addition there are numerous flaws in its execution of the review. These methodology and execution flaws render the DCAA estimation of unallowable executive compensation to be overstated and speculative." Mr. Jackson cites nine separate errors DCAA committed where the Board sustained eight of them finding Mr. Jackson's assertions "credible and unrebuffed" and ruled JF had met its responsibility of showing its executive compensation was reasonable.

The Boards findings were:

1. Ignored Data Dispersion/Used Arbitrary 10% ROR Allowance

This is the most significant flaw in DCAA's methodology which accounts for most of the compensation deemed unreasonable. The arguments presented are quite technical where the conclusion is the use of an arbitrary 10% ROR fails to measure the actual amount of dispersion among the data where if it was used, the 10% would be a lot higher. The Board agreed with Jackson concluding that use of a fixed 10% ROR rather than one based on the actual data variability is "arbitrary, unsupported, and unsupportable."

2. Ignored Differences in Survey Sizes

Jackson stated it is improper as a matter of statistical analysis to ignore the differences in sample size amounts between the surveys. He found the sample size of the

surveys ranged from only five companies to 110. He said DCAA's assumption that a 50th percentile from a survey having 110 companies is just as reliable as one with five companies represents a "statistical flaw." He stated DCAA should weight the surveys so a survey with 25 companies, for example, should receive five times the weight of one with five companies. DCAA's treatment of all equally is "unreasonable."

3. Failed to Consider Financial Performance Without Challenge

Jackson objected to DCAA automatically assuming every company should be in the 50th percentile when it establishes its initial position. Though this objection did not affect the trial (he did not assert a different percentile should apply) he wanted to stake out the position a 50th percentile should not be the default position.

4. Failed to Consider Other Discriminators Such as Security Clearances, Customer Satisfaction and Other Factors

Jackson stated the proper steps of a compensation review should include, step one the "art" of selecting the right surveys, step two the "science" of going from the surveys to preliminary results and step three consideration of other subjective factors such as a employees' security clearance, customer satisfaction, product quality and geographic location such as competing in the DC area. He asserted DCAA did not consider these third subjective factors.

Other findings included*: (5) Inconsistent Company Industry,* stating DCAA kept shifting "back and forth" as to what industry it was benchmarking *(6) Inconsistent Executive Positions* were benchmarked *(7) Inconsistent Usage of Different Surveys* where some were used in some years and dropped in others and *(8) Inconsistent Use of 50th Percentile Vs Mean* where the mean (average) was used on one survey while the 50th percentile was used in others.

Metron (ASBCA Nos. 56624, 56751 and 56752).

Most of the issues addressed by the board in this case centered around the Board's rejection of DCAA's attempts to adjust the results of one of the surveys it used – the Radford Survey - to benchmark Metron's executive compensation. The Radford survey showed significantly higher levels of compensation than the three other surveys DCAA used. The Board ruled against DCAA's modifications ruling:

1. The use of the Radord survey alone would be appropriate since it contained "the best information for salaries."

2. It was improper to lower compensation using regression analysis and best fit trend lines to adjust for the fact that the survey provided results for "below $50 million firms" while Meteon had revenue between $14M and $18 million. The Baord ruled there was no evidence supporting there was a direcgt relationship between higher revenue and higher compensation within the below $50 million goup.

Other findings that the Board ruled on included: (3) "senior engineers" were, in fact, senior executives (e.g. Chief technical officer) despite the fact there was no VP in their title (4) higher education levels and security clearances deserved price premiums (5) it was "unpersuasive to lower the percentile to 25% after stating the executives were "division managers" overseeing less revenue than that generated by the company as a whole and (6) the government "misanalysed its financial performance.

DCAA's Response

General Remarks

Interestingly, though it asserts it is responding to both cases, none of the conclusions in the Metron cases are addressed by DCAA. (*Editor's Note. DCAA;s approach to considering the Radford survey is to either add it to its other surveys when contractors present it and compute an average of all surveys or to reject it entirely asserting its high compensation levels make it an "outlier."*) DCAA states contractors have the burden of demonstrating the reasonableness of their compensation costs stating the mere citation of the JF Taylor decision does not demonstrate their claimed compensation costs are reasonable. As a result of its analysis of key points made in the cases, DCAA continues to follow its existing approach which it states were delineated in the *Techplan Corporation ASBCA decision (ASBCA No 41470)* and asserts its procedures are consistent with those followed by experts and professional organizations such as WorldatWork. Before addressing what it considers to be "significant flaws" in the statistical analysis conducted by JF Taylor's expert DCAA negates this analysis saying the Board accepted JF Taylor's expert opinion because it was "unrebutted" by the Government which the DCAA's comments are intended to rectify. (*This is not quite right. Though the Board did not accept the government's witness this does not mean they did*

not consider his arguments that DCAA's approach is sound. In fact, the Board did consider DCAA's approach and ruled it was flawed for reasons cited by JW Taylor's expert.)

Specific Response to JF Taylor's Statistical Analysis

1. *The expert's statistical approach of establishing an "Upper Limit on Reasonable Compensation" (ULRC) is not a proper approach.* DCAA asserts the statistical ULRC exceeds the highest compensation amounts reported in the surveys used, explaining the ULRC exceeded the 75th percentile and even the 90th percentile of the three surveys it used concluding this approach is not comparable with the pay levels of similar firms. (*A commentator, Darrel Oyer states this is untrue where the results are within the survey results, only at the high end.*)

2. *Expert's criticism of the 10% ROR is wrong.* DCAA disputes the Expert's assertion that the 10% ROR is a judgmental factor arguing the 10% factor is a measure of "central tendency" to account for market variations. Though it is not an exact science where the 10% ROR is not intended to account for all dispersion in survey data four compensation publications do accept the 10% ROR factor where it was also accepted by experts from both sides in the Techplan decision. DCAA states JF Taylor's expert is a statistics expert but, admittedly, is not an expert in compensation. (*Editor's Note. The Board was aware of this and nonetheless accepted his testimony stating a "compensation expert" was not required.*)

3. *The Expert's statistical recommendation do not reflect typical company pay practices.* DCAA asserts JF Taylor's ULRC approach does not reflect typical company pay practices where few companies peg their compensation above the 75 percentile level where the majority will prefer to target their compensation to the 50 percentile. DCAA selects its three surveys – WorldatWork, Watson/Wyatt and Mercer – to demonstrate the 50 percentile level is commonly selected where less than 6% use the 75 percentile. Accordingly, DCAA uses the 50 percentile unless superior financial performance can be demonstrated and then applies a 10% range of reasonableness (ROR) factor.

4. *The Expert's analysis did not consider company performance.* DCAA asserts the JF Taylor's approach gave no consideration to its financial performance as compared to its peers. Rather, the ULRC approach allowed compensation to exceed compensation of its peers regardless of whether their financial performance exceeded its peers and provided no justification of why its compensation should exceed that of its peers.

5. *Expert's analysis is based on the incorrect assumption that compensation is normally distributed.* The expert's analysis is based on the unsupported assumption that compensation levels form a "normal distribution" or bell shaped curve where compensation professionals state compensation is not normally distributed. Rather, compensation is normally clustered around the 50 percentile with a very small curve for high or low outliers.

6. *Expert's assertion that DCAA ignored differences in survey sizes is not valid.* DCAA defends its method of using flat average of surveys. Though it does not weight the surveys by size it states DCAA and other compensation professionals will use a different method to ensure no one survey skews overall results. DCAA defends its method of evaluating survey results for each position to determine if they represent a reasonable market trend (e.g. are the results fairly consistent with other surveys) and remove those that are clearly high or low as outliers.

7. *DCAA disagrees with the Expert's assertion that DCAA failed to consider discriminators such as security clearances, customer satisfaction and other factors that may explain variances in compensation.* DCAA states it rarely considers such discriminators as "qualitative" and are already included in survey results. Such factors as quality performance are considered by DCAA to be subjective where there is little empirical evidence. As for advanced degrees, many contractor employees are assumed to have these degrees (e.g. MD or JD or medical or attorney performance) but sometimes advanced degrees may be grounds for premium pay if they are directly related to a company's performance and can be shown to give a company a competitive edge. As for security clearance, survey data will usually not reflect it since requisite clearances are common. The only premium for security clearances DCAA finds acceptable is for sign on bonuses for new cleared employees who do not need to expend the effort to obtain clearances.

Oldie But Goodie…

COMPETING FOR PROFESSIONAL SERVICES CONTRACTS

(*Editor's Note. In this competitive marketplace, there are a lot of attempts to bid prices that "cheat the system", resulting in "wage*

busting", overly optimistic overhead projections and plain "buy ins". These practices are particularly prevalent in professional services contracts where the solicitation lists total hours to be provided and offerors are asked to merely propose base salary rates, overhead and profit.

How do you compete in this environment? The following article identifies some tactics you are likely to encounter or may even choose to use and measures you can take to lessen the impact of unfair competition for professional services. We wrote an article over 20 years ago and were surprised to see the insights are as valid today as back then and we have updated many of the ideas to correspond to subsequent regulation and court changes (e.g. uncompensated overtime, bait and switch tactics, discussions). Though the article explicitly addresses professional services it is quite relevant for other types of contracts.)

We will address compensation plans, key employee resumes and uncompensated overtime and recommend actions to counter competitors' low bidding practices.

Compensation Plans

The offeror may promise to hire the highest quality professionals, including a promise to hire the best of the incumbent's personnel. The source selection official will often analyze the offeror's compensation plan to determine if it is sufficient to attract and retain quality professionals.

- **FAR Requirements**

The Federal Acquisition Regulation – "Evaluation of Compensation for Professional Services" (FAR 52.222-46) - require the submission of a compensation plan for solicitations of negotiated service contracts exceeding $700,000. The plan must set forth proposed salaries and fringe benefits for professional employees working on the contract as well as supporting data used to establish the compensation plan such as recognized salary surveys. The purpose of this requirement is to make sure that lower salaries do not make it difficult to attract and retain competent professionals so that the quality of service may be maintained. Should the CO fail to include this provision in the solicitation, you should raise this issue prior to the closing date for receipt of initial proposals.

- **Plan Requirements**

The plan must be specific to the solicitation requirements. For example, if a contract specification requires proposed engineers to have 10 years experience with military software testing, it is not sufficient you demonstrate that software engineers can be hired at a given salary but you must demonstrate that professionals having the 10 years experience can be attracted and retained at the pay levels proposed.

If you expect your proposed salary rates will be lower than the incumbent contractor, you need to be prepared to present special facts to explain your ability to offer lower rates and include them in the compensation plan. These facts may include (1) numerous recent hires at entry-level salaries (2) lower salaries in your geographic area (3) downturn in the economy or lower-paid employees more readily available (4) special concessions offered by existing employees (5) unusual fringe benefit arrangements such as flexible working hours, "work-at-home" plans, daycare benefits, etc. Of particular importance will be historical evidence you have been able to hire quality professionals at the compensation proposed coupled with historical evidence you have not experienced excessive turnover.

- **Government Evaluation of Plan**

Upon receipt of proposals, the source selection officials must review the compensation plans. The level of review will depend on how much the proposed rates deviate from those of the incumbent and the presence of language elevating the importance of the compensation plan. While proposed rates that are in line with incumbent salaries will most likely not require a detailed review, proposed rates considerably higher or lower will require a thorough review by procurement officials. A General Services Board of Contract Appeals case stated that compensation rates between 13 percent and 38 percent below the government's estimate indicated the presence of "wage busting" and represented an inadequate compensation plan.

Under recent changes to the FAR 15, the government is obliged to apprise an offeror of perceived shortcomings with its compensation plan during the process of conducting discussions during its negotiations.

- **Impact of an Inadequate Plan**

An adverse evaluation of the plan can affect a determination of whether the offeror is "responsible". The failure to demonstrate it can attract or retain qualified personnel means it lacks the resources to perform the work and hence is not a responsible offeror. An inadequate compensation plan can also be viewed as evidence of a failure to comprehend the complexity of work required, resulting in a lower technical evaluation.

More commonly, if an offeror's compensation plan is considered inadequate, the government may adjust its proposed price upward to reflect more reasonable compensation rather than devalue its technical score. The use of "cost realism" analyses by the government on both cost and fixed price contracts lead to adjustments of "low ball" offers. If cost realism is a mandatory requirement of the solicitation, a "low ball" offer can be thrown out. You may want to request that a cost realism analysis be a mandatory requirement.

Key Employee Resumes

Since the government is largely buying time and expertise of professionals on these types of contracts, it needs information about the people each offeror proposes to use. This information is contained in resumes of key personnel.

- **"Bait & Switch"**

Some competitors may use resumes to gain an advantage by proposing high-quality, high priced professionals for evaluation but using low-quality low-priced individuals for actual performance. All government appeal boards and courts have strenuously denounced "bait and switch" tactics ruling that when quality of personnel is a key evaluation factor, a proposal may be rejected if the offeror (1) does not intend to use all of the proposed key personnel (2) does not affirmatively determine the availability of the key personnel or (3) fails to notify an agency in the final stage of a selection of the need to substitute key personnel due to changed circumstances.

A prerequisite for using a resume for a key personnel is that the offeror in fact makes an inquiry regarding future availability. It is not sufficient to merely review your personnel database to identify professionals with requisite skills. Once resumes have been submitted, you have a limited obligation to keep the CO apprised of changes in the status of proposed key personnel. This does not mean that all substitutions of personnel after award are prohibited as long as the awardee acted "reasonably and in good faith".

The Courts have ruled that hard evidence of bait and switch tactics include (1) failure to inquire about availability (2) affidavits from individuals whose resumes were submitted that the offeror failed to discuss the intended participation prior to proposed submissions (3) clear commitment of the individual to other work (4) use of labor rates wholly inconsistent with personnel proposed or (5) internal memorandum indicating intent not to use the personnel proposed. Nonetheless, be advised that recent cases have generally ruled that assertions of bait and switch tactics are often rejected by the courts.

- **Certified Resumes & Letters of Commitment**

Contractors are more effectively protected against "bait and switch" substitutions when the solicitation requires a formal commitment with each proposal of the availability and commitment of the persons whose resumes are submitted. Such commitments often take the form of "certified" resumes and "letters of commitment". A "certified" resume is typically defined as a resume signed by both the offeror and person represented certifying the information is true and complete and is available to work on the contract. "Letters of commitment" are letters from key personnel not employed at the time of offer that states they acknowledge their resume will be used in the offer and that they intend to accept a reasonable offer of employment should an award be made.

Though non-incumbents often face a disadvantage in securing a workforce with relevant experience they, nonetheless, cannot expect to meet key employee listing requirements by promising to hire the incumbent's key employees. They must either (a) contact the incumbent's personnel and obtain permission to use their resumes or (b) offer other qualified personnel with their consent and advise the government they will consider incumbent personnel for any openings that may arise.

Uncompensated Overtime

Uncompensated overtime is defined as the hours worked in excess of 40 hours per week without additional compensation by employees exempt from the Fair Labor Standards Act who are directly charged to the contract. These employees are salaried executives, administrative or professional employees (*be aware that recent changes has eliminated the FLSA exemption from salaried employees making less than around $50,000 per year*).

A method of proposing low labor rates when salaries cannot be reduced is to require exempt employees to work overtime without additional compensation. Though there have been recent changes to the regulations as well as numerous new guidelines auditors are expected to follow the government is still vacillating in its approach to uncompensated overtime. Proponents of using uncompensated overtime stress that it reduces

the cost of services to the government through lowered labor rates while critics stress its unbridled use leads to dissatisfied workers, high employee turnover and a general reduction in quality. This difference of opinion is often reflected in solicitations where it is often clear use of uncompensated overtime is not prohibited while offerors are often warned that proposing uncompensated overtime may result in an offer being downgraded technically.

The Defense Department has stressed the potential for abuses citing examples of contractors who do not record overtime hours playing games by working one contract during normal hours (e.g. cost type) while another contract during the unrecorded time (fixed price or commercial). Auditors often provide conflicting guidance but commonly attempt to determine (a) whether contractors are charging all hours and when significant, urge them to do so (b) hours are allocated fairly among various contracts and (c) each hour worked is allocated its fair share of overhead costs. Government auditors have prescribed acceptable and non-acceptable methods that is beyond the scope of this article to cover.

- **Proposal Evaluation**

A proposal that includes uncompensated overtime must be carefully reviewed. First, the proposal must conform to mandatory accounting rules (DCAA allows three methods). Second, the government must assure itself the proposed rates will be delivered. On fixed type contracts, there is less concern where the government will be primarily concerned that rates are not so low as to endanger performance. For cost-type contracts, unless uncompensated overtime can be compelled by agreement or rates are "capped", there is considerable risk the government will not realize the benefits. Third, source selection officials must ensure the level of uncompensated overtime will not lower the quality by the offeror "buying-in". Lastly, source selection officials may perform "cost realism" analyses where if it is determined that performance may suffer or uncompensated overtime rates cannot be compelled, it may adjust proposed rates. However, adjustment to rates cannot be made under cost realism reviews unless these two conditions are met.

Recommendations

You should be prepared to defend your proposed labor costs and be on the look-out for ways to challenge competitors out to "game the system."

1. Under the FAR "Evaluation of Compensation for Professional Services" provision, you must submit a well-thought-out compensation plan with your proposal. Include copies of compensation studies supporting your rates – preferably salary surveys. If your salary ranges fall near the bottom of a survey submitted, be prepared to anticipate government questions by providing (1) explanations to support your rates (2) historical evidence of success in hiring and retaining quality personnel and (3) special facts that might cause a professional to work for you for less salary.

2. If you suspect your competitors are paying or planning to pay significantly less than you, include in your compensation plan surveys that might pertain to geographic area, company size and professional expertise. Provide a narrative describing trends or developments that would make your competitors' low wages unrealistic (e.g. statistics showing a shortage of professionals in relevant disciplines).

3. If the solicitation does not include the FAR "Evaluation of Compensation for Professional Employees" provision, formally request the solicitation be amended to include it. Also request that a cost realism analysis be a mandatory requirement.

4. Review the solicitation to determine if "specified resumes" or "letters of commitment" for key personnel are required. If not, formally request they be included.

5. Prior to submitting employee resumes, make sure the proposed professionals are available to work on the contract. If an employee must relocate, you should contact them to verify their willingness to do so and document the agreement by an internal memorandum or a signed statement.

6. If proposed key personnel are not current employees be sure to contact them to obtain their consent to use their resume. No formal employment agreement is required but you need acknowledgment their resume is being submitted and they are willing to accept employment under reasonable terms. Document communications.

7. Do not use resumes of incumbent contractor personnel unless you have contacted them and obtained their consent to use their resumes and agreement to consider employment.

8. If a competitor is selected, request a debriefing and attempt to obtain names of the key professionals. If you are the incumbent, ask employees if they were contacted.

If your attorney doesn't object, consider contacting non-employee personnel the competitor relied upon and determine their level of pre-commitment.

9. Monitor the awardee to determine if the assigned professionals match the resumes of personnel submitted. If not, consider filing a protest.

10. If you or your subcontractors plan on using uncompensated overtime, make sure that (a) you estimate overtime in the same way uncompensated overtime is accounted for and reported on your ongoing operations (2) the resulting workload will not render performance risky due to loss of key personnel or inefficiencies and (3) you and your subcontractor's use of uncompensated overtime is delineated in your proposal.

11. If a competitor is selected for award at a significantly lower price, request a debriefing and ask if uncompensated overtime was proposed. Consider filing a protest alleging (a) an inadequate compensation plan (b) excess uncompensated overtime and (c) inability to recruit and retain professionals at the salary level and uncompensated overtime levels proposed.

RAYTHEON CASE ADDRESSES COST IMPACT RULES FOR ACCOUNTING CHANGES

(*Editor's Note. The following case addresses several issues related to how contractors must show the cost impact of one or several simultaneous cost accounting changes. Though the CAS-related rules formally apply to contracts covered by the cost accounting standards we find, in practice, the following case may apply to non-CAS covered circumstances where the government often asks contractors to demonstrate the impact of accounting changes on all their government contracts, whether they are CAS covered or not.*)

Background

In fiscal years 2004-2006 Raytheon made several cost accounting changes where in 2004 there were four, in 2005 there was one and in 2006 there were three changes. In accordance with FAR 52.230-2, Cost Accounting Standards of its contract, Raytheon submitted modifications to its CAS Disclosure Statement describing the changes (Rev. 1 for 2004, Rev. 5 for 2005 and Rev. 15 for 2006) and provided to the Defense Contract Management Agency a rough order of magnitude (ROM) each year for the cost impact of the changes.

- **Rev. 1**

In its ROM for 2004, submitted in April 2006, one of the accounting changes resulted in increased costs of $313K (rounded off to nearest thousands) to it flexibly-priced contracts and a decrease in costs of $281K to its fixed price contracts. The other three changes had the opposite effect: they decreased costs on flexibly priced contracts and increased them on fixed price contracts where, collectively, three changes resulted in $660K in decreased costs for flexible contracts and $518K in increased costs to fixed price contracts. These distinctions are important because as we will see the government takes the position that increased costs of $313K to its flexibly-priced contracts and its decrease in costs of $281 to its fixed price contracts for the first accounting change cannot be offset by the opposite effect of decreased costs resulting from the other three changes. This question, whether multiple simultaneous accounting changes can be offset by each other is a central issue of this case.

In July 2011, DCMA's divisional administrative contracting officer (DACO) issued a final decision on the Rev. 1 for the first accounting change where it took the $772K that DCAA questioned and added a compound interest amount of $404K (calculated from Jan 1, 2004, the effective date of the accounting change to the date of the decision). The DACO said that FAR 30.606(a)(2) allowed him to resolve the cost impact, among other things, by adjusting the amount due on a single CAS covered contract.

- **Rev 5**

In July 2005 Raytheon submitted Rev. 5 of its Disclosure Statement that contained one accounting change for that year. In its April 2006 ROM for the Rev. 5 change, Raytheon stated this change resulted in $153K in increased costs to flexibly priced contracts and a decrease of $117K to fixed price contracts. The DACO took the same approach and added a compound interest amount to DCAA's ROM of $160K (calculated from Jan 1, 2005 to the date of its decision.

- **Rev. 15**

In Feb. 2010, Raytheon submitted a ROM analysis for the three changes calculating that one of the changes results in a $251K decrease to flexibly priced contracts

and an increase of $195K to fixed price contracts. The other two changes had the opposite effect – one of the changes caused an increase of $48K on flexibly priced contracts and $41K on fixed price contracts while the other change had an increase of $36K to flexibly priced contracts and a decrease of $17K on fixed price ones.

In its draft audit report DCAA acknowledged that considered as a whole, the three Rev. 15 accounting changes resulted in net decreased costs to the government of about $304K. However, DCAA stated that under FAR 30.606 (a)(3)(ii), the cost impact of unilateral changes could not be combined unless they all resulted in increased costs to the government. So in its final report, DCAA calculated a cost impact of $157K by adding the increases on flexibly price contracts and the decreases in fixed price contracts. Though the report recognized the changes resulted in decreased costs to the government of $446K ($251K plus $195K) it stated "there was no requirement for any adjustment related to this unilateral accounting practice change since adjustments are only made if changes result in increased costs to the government." In March 2012 the DACO issued a final decision determining that Raytheon owed the government the $172K consisting of DCAA's calculated amount plus compound interest from Jan. 1, 2006.

Issues to be Addressed

1. Whether a cost increase to the government from a contractor's unilateral cost accounting practice change can be offset against simultaneous but unrelated accounting changes that save the government money.

2. As DCAA customarily does, whether increased costs on flexibly priced contracts should be combined with decreased costs on fixed price contracts to calculate a total amount due when an accounting change shifts costs from fixed price to flexibly-priced contracts.

3. Whether the government is entitled to interest and if so, what type of interest.

4. Whether FAR 30.606, which prohibits offsetting the impact of multiple changes, is invalid to the extent it defines aggregate increased costs and prohibits the offset of multiple simultaneous changes.

5. Since more than six years elapsed from the time the revised disclosure statements identifying the changes to the time the Contracting Officer issued its final decision, did the Contracts Dispute Act's Statute of Limitations prohibit the government's recovery of costs from the accounting changes.

Decision

- **Offsetting Rev. 1**

Since the CAS rules allow the cost impact on all CAS covered contracts to be expressed in one flexible contract, which is referred to as "Contract 1," the Board asks "Are there any CAS provisions that address the procedures government agencies should follow if a contractor makes multiple simultaneous changes to its cost accounting practices?". Following *The Boeing Company, ASBCA Nos. 57749 and 57563)*, the Appeals Board concluded that for the time period at issue for Contract 1 for Rev. 1 (prior to April 2005) neither the CAS statute nor the CAS Board regulations addressed the offset of simultaneous accounting changes. Despite the absence of any CAS related provisions addressing simultaneous accounting changes, the Board ruled there were "established practices" in place that address offsets of such changes. Four examples were put forward of established practices: (1) a CAS Working group, assembled to carrying out the work of the CAS Steering Committee, issued Item 76-8 that determined "offsetting of simultaneous accounting changes within a segment was permissible and would serve to reduce the number of contract price changes." (2) The 2002 DCAA Contract Audit Manual at 8-102/2 expressly allowed the offsetting stating "within a segment, the effect of several changes may be combined to offset consideration if the changes all take place at the same time." (3) In Boeing, the Appeals Board relied on a memo prepared by the CO that documented the standard practice saying "prior to 2005, the impact of all of the accounting changes would be considered and netted together in determining if the government paid increased costs in the aggregate." (4) The FAR Council published a proposed rule on April 8, 2000 calling for the "offsets of increased costs to the government against decreased costs to the government for some or all contracts."

- **Rev. 15**

The contract for which the DACO sought to recover Rev. 15 amounts (Contract 11) is dated Dec, 30, 2004. Roughly three months later (March 9, 2005), the FAR Councils issued the final rule FAR 30.606. Though the proposed rule had expressly allowed offset of simultaneous changes, the final rule constituted a complete turnabout in that now it prohibited such offsetting. Rev. 15 did

not go into effect until Jan. 1, 2008 so though some contracts like Contract 11 predated the issuance of FAR 30.606, this revision also applied to some contracts executed after April 2005 where Raytheon estimated that about two-thirds of the contracts subject to Rev. 15 were executed after the regulation went into effect. So the issue is how should the board analyze the Rev, 15 changes when that revision applies to contracts both before and after the issuance of FAR 30.606.

Raytheon put forth, in part, two arguments to prevent the government from obtaining any amounts due to the changes and the Board ruled on them.

1. The first was because the CO seeks to recover all of the Rev. 15 funds from a pre-FAR 30.606 contract and there was no bar to such offsets at the time of contract execution of Contract 11 then the government's Rev. 15 claim fails in its entirety. The Board ruled that with respect to the contracts executed prior to the effective date of FAR 30.606 the regulations in effect on that date governs the offsets. The accounting changes Raytheon made in 2008 do not change the nature of the bargains the parties struck pre-FAR 30.606 ruling the contractor can offset the Rev. 15 contracts that the parties executed prior to April 8, 2005, the effective date of FAR 30.606.

2. Raytheon's second argument is that the FAR Council, in issuing the regulation, exceeded their authority by acting in an area that Congress reserved exclusively to the CAS Board. The Board disagreed with Raytheon here. The Board spent several pages in its decision analyzing what areas only the CAS Board has authority over and what other areas are open for procurement agencies to make changes where, for example, it stated the CAS Board has primacy when it comes to the "measurement, assignment and allocation of costs." In addressing whether the FAR Council, in issuing FAR 30.606 overstepped their authority, the Board concluded the FAR provision did not address these three elements ruling the changes were more in the nature of contract administration or a policy determination.

- **Double Counting of Costs**

This is the critical issue where the result runs counter to the normal practice of DCAA and DCMA's method of computing impact of accounting changes. Raytheon contends that the government is seeking a double recovery on all three revisions because it seeks recovery for not only the increase in costs allocated to flexibly-priced contracts but also the corresponding decrease in costs allocated to fixed price contracts. Under Rev. 1, as a reminder,Raytheon reduced the costs allocated to its fixed price contracts by $281K and increased its costs to flexibly-priced contracts by $313K where it emphases these are the same costs. Though the government does not challenge Raytheon's assertion it nonetheless contends that these two figures should be added together.

Raytheon provides a simple example to illustrate what it views as the unfairness of the government's position. It creates a world where the Rev. 1 changes applies to only two contracts, one fixed-price and the other flexibly priced, both at $1 million. It then reduces the allocation to fixed price contract by $300K as a result of the change and increases the flexibly priced contract by the same amount. The value of the fixed price contract remains at $1 million since it is fixed price while the value of the flexibly priced contract is $1.3 million after the change resulting in a value of $2.3 million after the change compared to $2.0 million before the change. Under this scenario, if there are no adjustments to the contracts, the government would pay $2,3 million for the goods and services it contracted for which it expected to pay only $2 million. This would violate the statutory bar the government should not pay increased costs in the aggregate from changes. But this statute also prohibits the government from recovering greater than the aggregate increased cost to the government. As Raytheon pointed out, if the government recovers $300K it would be made whole because the government would then receive the same goods and services as before the accounting change and it would still pay a total of $2 million. Raytheon concludes any recovery over $300K would violate the bar on recovering more than the aggregate cost increase.

The government argues that it must recover the costs on the fixed price contracts because Raytheon would make a profit on these contracts in excess of that negotiated by the parties at the time of the award. It quotes FPR 9903.306 which states "if the contractor under its fixed price contract fails to follow its cost accounting practices or applicable CAS, 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."

The Appeals Board sided with Raytheon stating the quoted regulation must be read in the light of the statutory prohibition on recovering greater than the

aggregate increased cost to the government. The only exception would be if at the time of price negotiation the contractor failed to disclose the change to the government which the government does not allege here. Referencing Raytheon's example, the government's position would allow it to recover $300K on each contract (or simply not pay it). Here, though it originally contracted to pay $2 million, after the accounting change it would have received the same goods and services for $1.7 million. "This is the very definition of a windfall" which would be just as unfair as if no adjustments were made and Raytheon received $2,3 million. The Board ruled " the government may recover the increased costs allocated to flexibly priced contracts but it may not recover those same costs when they are removed from the allocation to fixed-price contracts."

- **Statute of Limitations**

The Board responded to four incidences of whether the six year statute of limitations clause of the Contract Disputes Act makes the DACO's final decisions untimely and hence eliminates any liability of Raytheon to adjust its prices. The Board stated the CDA requires a claim to be submitted within six years of the "accrual of the claim" which occurs when "all events that fix alleged liability and permit assertion of a claim were known or should have been known." The SOL clock does not begin to run until "the claimant learns or reasonably should have learned" of the cause of action. The board ruled the DACO's final decision was timely in one circumstance but untimely in three.

Rev. 1. Raytheon submitted to DCMA its revised Disclosure Statement identifying four accounting changes on Feb. 10, 2004 to be effective Jan. 1, 2004. The notice did not identify the total cost impact of the four changes or state whether they would cause any negative or positive impact to the government, advising it would submit a ROM "at a later date." On April 3, 2006 it submitted the dollar impact identifying the $313K impact on flexibly price contracts and $218K on fixed price ones. Raytheon argued the DACO's final decision on July 7, 2011 was untimely since it gave notice of the change on Feb 10, 2004 and the government had access to its accounting data to determine whether the impact was negative while the government argued it could not identify any cost impact until April 3, 2006 when Raytheon first provided its ROM which made the claim timely. The Board sided with the government stating the "knew or should have known" standard contains "an element of reasonableness" concluding though it knew of the change it did not know of the consequences of the change until April 2006, making the final decision timely.

Rev. 3. Raytheon submitted to DCMA a revised Disclosure on Nov 19, 2004 identifying two accounting changes and on the same date it reported a cost impact for one of the changes of $367K on flexibly priced contracts and $298K on FP contracts. On Feb 15, 2005 Raytheon submitted a revised ROM which adjusted the numbers downward slightly and another revised calculation was submitted April 3, 3006. Raytheon asserted its SOL began to run on Jan 1, 2005 based on its Nov 2005 submittal or at least by Feb 15, 2005 when the change was in effect an a revised submittal made, both of which would make the DACO's decision on July 11, 2011 untimely. The government disagreed stating Raytheon did not provide enough supporting documentation for the cost impact where the proper trigger date was April 3, 2006 making the final decision timely. The Board sided with Raytheon ruling the final decision was untimely stating that on Nov. 19, 2004 the government knew the changes would start to occur on Jan 1, 2005 and it knew of a negative cost impact on that date which is enough to start the SOL clock. Claim accrual does not depend on the degree of detail provided or whether the contractor revises the calculation later; it is enough that the government knows or has reason to know that some costs have been incurred even if the amount has not been finalized.

In two other revisions, similar facts were present where Raytheon argued the claims occurred on earlier dates while the government argued it did not have sufficient information to trigger claim accruals and the Board ruled in favor of Raytheon.

- **Interest**

Raytheon challenged the DACO's assessment of compound interest. The Board cited the CAS statute that provides for " a contract price, with interest, for any increased costs paid to the contractor." As for whether compound interest applied, the Board further cited the CAS statute that provides interest paid will be "compounded daily." Accordingly, the Board ruled the government is entitled to compound interest from the date of excess payments until the date the government is repaid in full.

Conclusion

With respect to Rev. 5 and 15, the board grants summary judgement in favor of the government with respect to compound interest. It grants summary judgement to Raytheon with respect to the double counting issue and that the government's claim was untimely in three of four incidents. It also rules in favor of Raytheon for the period before FAR 30.606 ruling offsets were proper but for the government after it became effective ruling that offsets were prohibited.

NEW CLAUSE FLOW-DOWN REQUIREMENTS

(Most subcontract agreements we examine are outdated, based on models developed as far back as 1984. They are boilerplate agreements that do not reflect recent changes to the Federal Acquisition Regulation – in particular, all FAR mandatory "flow-down" clauses (clauses in prime contracts that must be included in all first tier subcontracts and usually lower tier). The Committee on Federal Subcontracting Section of the Public Contract Law group of the American Bar Association's usually updates their "Guide to Fixed Price Supply Subcontract Terms and Conditions" every few years but has not done so since 2005. Instead the last submittal was "Guide to Service Subcontract Terms and Conditions" reasoning the government has been spending more on service contracts than supply contracts. The Guide is intended to assist both prime contractors and subcontractors draft subcontracts for service contracts (though it explicitly applies to "service contracts" our inquiry to a member of the committee who wrote it said it generally represents good guidance for supply contracts also since most mandatory clauses apply to both types of contracts). The mandatory list should represent a good education tool - a study of all the FAR clauses is a daunting task but since the mandatory list represents the "key" terms and conditions of doing business with the federal government they are a good area to focus your attention on. The FAR and DFARS references are those in effect on July 15. 2007.)

The Committee has identified all mandatory clauses it believes are necessary. The publication identifies the clauses for both government-wide and Department of Defense use, provides full text of them, offers other provisions that parties may want to consider including and subcontracting clauses for commercial items. We will limit this article to listing the new mandatory as well as a few key clauses that though not mandatory are highly recommended. You can receive the publication by calling the ABA Service Center at 1-800-285-2221.

The following provisions are now *mandatory* FAR Clauses:

52.203-6, Restrictions on Subcontractor Sales to the Government. Applies to orders exceeding $100,000.

52.203-7, Anti-Kickback Procedures. Applies if order exceeds $100,000.

52.203-11 and 12, Certification and Disclosure as well as Limitation on Payment to Influence Certain Federal Transactions. Appkies if order exceeds $100,000.

52.204-2, Security Requirements. Applies if subcontracts involve access to classified information.

52.204-9, Personal Identify Verification of Contractor Personnel

52.211-15, Defense Priority and Allocation Requirements.

52-215-2, Audit and Records – Negotiation. Applies if prime contract was awarded through negotiations, exceeds the simplified acquisition threshold of FAR 13.

52.215-10 and 52.215-11, Price Reduction for Defective Cost or Pricing Data . Applies if the prime contract was awarded through negotiations.

52.215-12, Subcontractor Cost or Pricing Data. Applies when prime contract over $700,000 was awarded through negotiation where certified cost or pricing data was submitted.

52.215-13, Subcontractor Cost or Pricing Data – Modifications. Same conditions as 52.215-12.

52.215-14, Integrity of Unit Prices.

52.215-15, Pension Adjustments and Asset Reversions.

52.215-18, Reversion or Adjustment of Plans for Post-retirement Benefits (PRB) Other than Pensions (Oct 1997). Same conditions as 52.215.15

52.215-19. Notification of Ownership Changes.

52.219-8, Utilization of Small Business Concern. Applies only if other subcontracting opportunities exist.

52.219-9, Small Business Subcontracting Plan.

52.222-4, Contract Work Hours and Safety Standards Act – Overtime Compensation.

52.222-21, Prohibition of Segregated Facilities.

52.222-22, Previous Contract and Compliance Reports.

52.222-26, Equal Opportunity. Only Subparagraph (b)(1) through (11) is mandatory.

52.222-35, Affirmative Action for Special Disabled and Vietnam Era Veterans (Dec 2001). Applies if order exceeds $10,000.

52.222-36, Affirmative Action for Handicapped Workers. Applies if order exceeds $2,500.

52.222-37, Employment Reports on Special Disabled Veterans and Veterans of the Vietnam Era. Applies to orders exceeding $10,000.

52.222-39. Notification of Employee Rights Concerning Payment of Union Fees.

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52.222-41. Service Contract Act of 1965, as Amended.

52.222-50. Combating Trafficking in Persons.

52.223-7, Notice of Radioactive Materials

52.223-13 and 14. Certification and Reporting of Toxic Chemical Release.

52.225-1, Buy American Act – Supplies (Jun 2003). Applies only is seller is supplying an item that is an end product under the buyer's prime contract.

52.225-13, Restrictions on Certain Foreign Purchases (Dec 2003).

52.227-1, Authorization and Consent.

52.227-2, Notice and Assistance Regarding Patent and Copyright.. Applies to orders exceeding simplified acquisition threshold.

52.227-10, Filing of Patent Application – Classified Subject Matter. Applies to orders covering classified subject matter.

52.227-11, Patent Rights – Retention by the Contractor

52.228-3, 4 and 5. Worker's Compensation Insurance.

52.230-2, Cost Accounting Standards.

52.230-3, Disclosure and Consistency of Cost Accounting Practices

52.230-6, Administration of Cost Accounting Standards.

52-244-6, Subcontracts for Commercial Items.

52.245-1, Government Property.

52.245-18, Special Test Equipment.

52.247-63 and 64, Preference for US-Flag Air Carriers.

52.248-1, Value Engineering.

252.215-7004, Excessive Pass-through Charges

Significant clauses that are advisable are:

52.215-20. Requirements of Cost or Pricing Data or Information Other than Cost or Pricing Data.

52.249-1, 2, 3 or 4 and 62. Termination for Convenience.

52.249-8 and 9, Default.

52.227-14, Rights in Data-General.

52.229-1, 3 and 4. Federal, State and Local Taxes.

52.233-3, Protest After Award.

52.252-15, Stop-Work Order.

52.242-17, Delay of Work.

52.243-1, Changes-Fixed Price.

It is anticipated that the parties will negotiate their own terms and conditions on commercial item subcontracts

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