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ASBCA Case on CAS Cost Impact Reconfirms That a New Regulatory Requirement Does Not Apply to Existing Contracts

By Michael Steen, CPA, Senior Director at Redstone Government Consulting, Inc.

In ASBCA Cases (57549, 57563) the issue involved multiple unilateral changes to cost accounting practices effective on the same date (January 1, 2005) for two segments of a large contractor. The contractor, subject to the administrative requirements of CAS (Cost Accounting Standards), computed its cost impacts using the aggregate cost impact netting increased costs and decreased costs applicable to CAS covered contracts for each of the segments, respectively. The aggregate net increase for one segment was $398,000 which reflects two changes which decreased costs and another change which increased costs. The aggregate net decrease for the other segment was $5,851,000 which reflects four changes which decreased costs and two changes which increased costs.

In these ASBCA cases, the cost impacts applied to CAS covered contracts executed before 2005, highly significant to the extent that FAR Part 30.606 effective April 8, 2005 added new and very restrictive terms for resolving cost impacts, in particular, "the cognizant Federal agency official shall not combine the cost impacts of any of the unilateral changes unless all changes result in increased costs to the Government". (Editor's note, this requirement essentially forces a contractor to individually compute the cost impact for each unilateral change; otherwise there is no way to determine if each change results in increased costs). The essence of the dispute--the Government asserted that the April 2005 FAR change merely incorporated the June 2000 revisions to CAS 9903.201-6; hence, the January 1, 2005 cost impacts could not net one or more changes which decreased costs with any changes which increased costs. The contractor asserted that the April 2005 changes were not in pre-existing contracts and, in fact, DCAA and DCMA guidance or interpretations indicated that prior to April 2005, the regulations permitted aggregate cost impacts for unilateral changes effective on the same date at a business segment ("contractor").

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In its decision, the ASBCA bluntly stated that the Government assertion "is not correct"; specifically, there is no provision in 9903.201-6 or any other regulation prior to 8 April 2005 prohibiting the combination of two or more simultaneous accounting practice changes to determine the aggregate cost impact. Although the ASBCA indicated that the regulations were silent (prior to April 2005) with respect to offsetting the cost impact from simultaneous changes, the ASBCA did rely on DCMC (now DCMA) and DCAA manuals which stated that within a segment, several accounting practice changes may be combined for offset purposes as long as they have the same effective date.

The ASBCA concluded that the contractor could combine the 1 January 2005 cost accounting practice changes at each segment for purposes of computing the aggregate cost impact. In supporting this conclusion, the ASBCA stated (and reconfirmed prior decisions) that "the regulations applicable to a contract are those in effect at the time the contract was executed". In deciding entitlement for the contractor, the ASBCA noted that all CAS covered contracts were executed prior to 1 January 2005; hence, the ASBCA need not interpret FAR 30.606 (i.e. the specific regulation simply did not exist prior to April 2005).

Although relatively few Government contractors are subject to CAS, the significance of this ASBCA decision goes beyond CAS. This decision reconfirms and reinforces that a contract is subject to the regulations applicable on the date the contract is executed; in particular a contract includes the Allowable Cost and Payment Clause (FAR 52.216-7), the FAR Cost Principles (Part 31) and CAS Administration (Part 30, if CAS covered contract) in effect on the contract execution date. Noting that Government contract regulations are periodically revised and that revisions are predictably unfavorable to contractors, it is important to recognize that Government auditors and Contracting Officers have a tendency to inappropriately apply current regulations to historical costs. One example, FAR 31.205-46(b), changed effective January 11, 2010 to limit airfare to lowest available in contrast to the previous version which was standard coach or equivalent. In a number of cases, DCAA incurred cost audits for contractor fiscal years before 2010 inappropriately refer to the current travel cost limitations. Perhaps even more egregious (because the FAR Councils should know and understand that regulatory changes are prospective and are not applicable to existing contracts), on June 26, 2013, FAR 31.205-6(p) was revised to expand the statutory limitation on compensation to all contractor employees (not just the top five per the prior regulation). This FAR change (interim rule) was retroactive to contracts executed on or after December 31, 2011 and a second interim rule applied this new regulation to costs applicable after December 31, 2011 on contracts executed before December 31, 2011.

In reference to disagreements with contractors in terms of when to apply the June 26, 2013 FAR change, Government Contracting Officers appear to be oblivious to the long standing legal interpretation that a contract is subject to the clauses in effect on the date of the contract and that retroactive changes constitute a Breach of Contract. Recent experience has shown that neither DCAA auditors nor Administrative Contracting Officers can understand why a contractor would not accept retroactive application of revised contractual clauses unfavorable to the contractor. A contractor might voluntarily accept a revised regulation in retroactive application to maintain good customer relationships; however, if the revised regulation has a significant unfavorable cost impact on contractor cost recovery, a contractor should consider "agreeing to disagree". Just be prepared to try explaining the logic even though auditors and contracting officers should know and understand the very fundamental principle that a Government contract is subject to the clauses in effect on the date of contract execution.

Unilateral Changes in Cost Accounting Practices: When Do Contractors Owe Disclosure and Cost Impact Calculations?

By Darryl L. Walker, CPA, CFE, CGFM, Senior Director at Redstone Government Consulting, Inc.

Many companies doing business with the government must continuously evaluate their cost accounting practices for compliance with the ever-changing government procurement trends and regulations, while also determining if changes in company business activities, structure, and customer revenue and policies necessitate alterations in accounting practices to ensure that allocation, assignment and measurement of costs

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to government contracts can be maintained. Depending on the regulations which are applicable to government contracts, a contractor may face rigid regulatory administrative hurdles and barriers when making changes to its practices, particularly when the company's existing practices are already considered compliant.

Small business contractors on a fast-track in government customer expansion are often those who most frequently make changes in cost accounting practices, whether due to the addition of a new product or service, extension of services in different geographical locations, award of huge dollar contracts that triple annual revenue, or other business events where shifts in cost allocations are required to maintain compliance with government cost accounting regulations. Such company life changing events can precipitate "unilateral", also known as "voluntary", changes in cost accounting practices.

The term "unilateral" is defined in the context of the Cost Accounting Standards (CAS), a specific statute with more specificity in allocation, measurement and assignment of costs to government contracts to which the CAS statute applies, as opposed to general, less specific FAR Part 31 Cost Principles or supplemental agency cost regulations. A unilateral change, as defined by CAS, is a change from one compliant to another compliant practice, thus such changes are at the discretion of the company and are not mandatory—mandatory or required changes are ordinarily a consequence of a new or revised regulation, or a non-compliance event that requires a change in practice.

Contractors performing CAS covered contracts or subcontracts must disclose a unilateral change sixty days before implementing the change and prepare a cost impact calculation for the ACO to determine if an increase in negotiated price and/or accumulated costs to existing CAS covered contracts, in the aggregate, will arise; if a projected increase in costs to covered contracts is determined, the government in not required to bear any such cost increases unless the new practice is deemed "desirable" (FAR 30.603-2 (a) & (b)). The government most frequently renders such changes as not desirable in which case the contractor bears the burden of increased costs to CAS covered contracts and subcontracts.

Government contractors who have no CAS covered contracts (due to various exemptions afforded under CAS 9903.201-1(b)) escape all contract administrative requirements relevant to unilateral cost accounting practice changes—without contracts containing CAS implementing provisions, such as FAR 52.230-6, a contractor cannot be held by any government agency to any specific requirement for disclosure of change in a cost accounting practice, preparation of cost impact on government contracts, nor can non-CAS contractors be barred from passing on increases in costs to government contracts resulting from those changes.

Unfortunately, some government auditors and contracts administrators attempt to apply the CAS provisions for unilateral changes to contractors having no CAS covered contracts or subcontracts. Auditors and/or ACOs often times become aware of implemented "unilateral changes", or to be implemented, by a non-CAS covered contractor during reviews of its forecasted provisional indirect billing rate proposals or other cost data, and subsequently attempt to enforce the CAS administrative conditions and procedures that are attached to unilateral changes. Although government officials do not always invoke the specific CAS regulations (mandating cost impact calculations and prohibiting recovery of contract cost increases on contracts where there are no enforceable restrictions), the government's notion it can hold non-CAS covered contracts to parallel CAS unilateral cost accounting change criteria obviously stems from a misguided perception that the government reserves a discretionary authority to impose similar non-existent rules to non-CAS covered contracts.

The government has no regulatory authority to apply the unilateral cost accounting change administrative requirements, which are explicitly limited to CAS covered contracts, to contracts that are exempt from CAS. Verbiage in CAS 9903-201(b) makes it clear that exemptions from CAS are mandatory, not discretionary—the language states exempted contracts "are exempt from all CAS requirements". The government therefore has no authority to demand application of the CAS rules related to unilateral changes to non-CAS contracts, nor any other administrative procedures requiring a contractor to potentially absorb cost increases to government contracts resulting from such changes.

Bottom line: non-CAS contracts contain no conditions for disclosure of unilateral changes in cost accounting practices

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nor are there specific provisions allowing the government to withhold payment of increases in contract costs due to the implementation of unilateral changes. However, the government is not prohibited from determining that existing or newly implemented cost accounting practices are not compliant with FAR Part 31 Cost Principles or supplemental agency regulations. Should auditors and/or the ACOs deem that existing practices are not compliant via a formal audit or ACO finding, contractors would have to consider changing practices to bring such practices into compliance. However, should increases to government contracts result from mandatory changes because practices were non-compliant with FAR Part 31 or other non-CAS regulations, no regulation blocks recovery of those increases (Editor's note: Although counter-intuitive that the government would take issue with a non-compliance even though correcting the alleged non-compliance increases costs on government contracts, there have been cost allocation issues where acquiescing to the government assertions has yielded increased cost allocations much to the surprise of the auditor and contracting officer).

DCAA Issues Guidance on Completing Forward Pricing Rate Audits

By Darryl L. Walker, CPA, CFE, CGFM, Senior Director at Redstone Government Consulting, Inc.

The Defense Contract Audit Agency (DCAA) has issued instructions to field auditors affirming DCAA's commitment to follow a July 2013 change in DCMA policy, which encourages the completion of Forward Pricing Rate Recommendations (FPRR) within 30 days of the receipt of a contractor's forward rate proposal (FPRP), so as to expedite negotiation of Forward Pricing Rate Agreements (FPRAs). DCAA states that all audit teams should continue to strive to complete FPRP audits "expeditiously" to facilitate establishing DOD positions in negotiating FPRAs, those agreements of which will facilitate negotiation of future negotiated pricing actions. For obvious reasons, DCAA fails to explain that the July 2013 DCMA policy is DCMA's attempt to mitigate the delays and disruptions to the acquisition process caused by DCAA's inability to timely complete even high priority forward pricing rate audits.

Earlier this year, DCMA formally amended their Instruction 130 mandating administrative contracting officers (ACO) to establish an FPRA or FPRR for all contractors with more than $200 million in negotiated annual government sales in the prior fiscal year, unless an exception can be justified. In the updated Instruction, DCMA notes that to negotiate effective FPRAs, government cost monitoring teams will track affected contractor business forecasts and historical rate and factor trends ostensibly prior to the submission of a contractor rate proposal, in preparing for evaluation of FPRPs and thereafter negotiating FPRAs within 60 days after the submission of adequate contractor FPRP submissions.

The August 23, 2013 DCAA guidance memo (13-PSP-019 (R)) states that timely information on rates are necessary so that the Procurement Contracting Officers (PCOs) "can make informed procurement decisions" (negotiation of pricing actions), and the memo also notes that DCMA is enhancing their cost monitoring function of contractors (who may be subject to a FPRA agreement) so that the cost rate collection data can be combined with DCAA independent audits of contractor FPRPs in eventually settling forecast rate agreements.

In an effort to expedite FPRP/FPRA review and settlement, the DCMA approach states that involvement of technical specialists (including DCAA) may be avoided unless necessary "to close a critical gap of information".

Guidance to auditors encourages continuous communication between audit teams and the ACO to exchange real-time information regarding the on-going rate audit (and rate negotiation process with the contractor), and all information provided to the ACO must be reviewed by the audit supervisor before communicated to the ACO.

DCAA also addresses the question as to whether the absence of a contractor completed DFARS forward pricing rate checklist (under the new proposal submission rules), which should have been provided simultaneously with the rate proposal, should render the contractor's proposal inadequate with the proposal subsequently returned to the contractor. DCAA's propensity to frequently stymie any type of historical or forward pricing proposal audit and subsequent settlement process, based on inconsequential data omissions, is obviously a concern of the DCMA contracts divisions in achieving prompt FPRR determinations and FPRA

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negotiations. DCAA's answer to this question is for the auditor to alert the contracting officer of the omission of the checklist to determine the best course of action (Editor's note: the DFARS Forward Pricing Rate Checklist is a "proposed" rule which has not yet been implemented; however, DCAA's audit policy overlooks that mere "technicality").

DCAA Real-time Labor Audits or Floorchecks

By Michael Steen, CPA, Senior Director at Redstone Government Consulting, Inc.

As noted in our August Newsletter, DCAA issued an audit policy (13-PPS-015(R), July 30, 2013) concerning *Access to Contractor Employees*, primarily for the purpose of auditor inquiry and observations confirming that employees physically exist and that labor charges are to the appropriate cost objective. Although DCAA is probably overstepping its authority by asserting the Access to Records provision (FAR 52.215-2) includes access to contractor employees, few if any contractors prohibit DCAA from contacting employees for the limited purpose of confirming labor charges on a real-time basis. More important to a contractor, the cost of supporting a DCAA real-time labor verification audit or floorcheck, should be significantly less than dealing with DCAA's after the fact documentation requests for years during which DCAA failed to perform real-time testing (this assumes that DCAA follows it July 30, 2013 guidance wherein the purpose of real-time audits is to document reliance on the labor charging system during a contractor fiscal year which should minimize testing years later during the incurred cost audit).

As with any DCAA audit, the "glass is always half-empty" because there is some contractor risk of issues including those in deciding if/how to intervene during a floorcheck. No contractor should allow DCAA to floorcheck (interview) contractor employees without accompanying DCAA with a contractor representative (audit liaison) who knows to intervene when necessary. Although DCAA auditors frequently demand that the audit liaison remain silent, DCAA inquiries sometimes demand intervention. For example, DCAA now appears to be mixing audit inquiry with investigative inquiry including questions (directed to randomly selected contractor employees) such as the following:

- Do you know of any fraud or suspected fraud affecting the subject matter of the audit?
- Are you aware of any allegations of fraud or suspected fraud such as communications from employees, ex-employees, regulators or others?
- Are you aware of any risks of fraud including any specific fraud risks the contractor has identified or account balances or classes of transactions for which risk of fraud may be likely to exist?

Noting that DCAA does not even have any regulatory authority to access contractor employees, a contractor which allows DCAA floorchecks (as a courtesy and/or just trying to get along) should consider intervening when appropriate. Investigative questions are beyond anything which can be related to the validity of an employee's time charge at a point in time; moreover, the three "fraud related" questions are basically a trap. If an employee answers "yes" to any of the three questions, that employee should be prepared to respond to a flurry of follow-on questions including those concerning if/how/when the employee reported his/her concerns to a Government Agency Hotline. If the employee knows of any fraud or suspected fraud, yet failed to report it, the contractor can assume that DCAA is going to assert that this is an internal control issue and/or failure to comply with the "mandatory disclosures" provision of FAR 52.203-13. It was bad enough (and illogical on the part of DCAA) during previous floorchecks (2011) when DCAA auditors were asking production employees to explain the difference between direct and indirect cost accounting; but now DCAA has added questions which have converted labor charging audits into the DCAA Inquisition. Apparently DCAA can no longer draw the line between "audits" and "investigations".

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Hilton Head Island, SC

October 20-21, 2014 – Accounting Compliance for Government Contractors
Las Vegas, NV

Instructors

- Mike Steen
- Darryl Walker
- Scott Butler
- Courtney Edmonson
- Cyndi Dunn
- Wayne Murdock
- Cheryl Anderson
- Asa Gilliland
- Adam Collet

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Our Company's Mission Statement: RGCI enables contractors doing business with the U.S. government to comply with the complex and challenging procurement regulatory provisions and contract requirements by providing superior cost, pricing, accounting, and contracts administration consulting expertise to clients expeditiously, efficiently, and within customer expectations. Our consulting expertise and experience is unparalleled in understanding unique challenges of government contractors, our operating procedures are crafted and monitored to ensure rock-solid compliance, and our company's charter and implementing policies are designed to continuously meet needs of clients while fostering a long-term partnership with each client through pro-active communication with our clients

In achieving government contractor goals, all consulting services are planned and executed utilizing a quality control system to ensure client objectives and goals are fully understood; the right mix of experts with the proper experience are assigned to the requested task; clients are kept abreast of work progress; continuous communication is maintained during the engagement; work is managed and reviewed during the engagement; deliverables are consistent with and tailored to the original agreed-to scope of work, and; follow-up communication to determine the effectiveness of solutions and guidance provided by our experts.

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Redstone Government Consulting, Inc. will develop and provide specialized Government contracts compliance training for client / contractor audiences. Topics on which we can provide training include estimating systems, FAR Part 31 Cost Principles, TINA and defective pricing, cost accounting system requirements, and basics of Cost Accounting Standards, just to name a few. If you have an interest in training, with educational needs specific to your company, please contact Ms. Lori Beth Moses at lmoses@redstonegci.com, or at 256-704-9811.

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