DoD Guidance on Contractor Accounting Changes Stirs Debate: DoD Guidance on Cost Impact Calculations for Unilateral CAP Changes

On October 3, 2023, the Defense Contract Audit Agency (DCAA) issued a Memorandum for Regional Directors (MRD)[1] revising its audit guidance related to the cost impact calculation for unilateral cost accounting practice (CAP) changes. Also, on October 3, 2023, the Defense Contract Management Agency (DCMA) issued a Contracts Executive Directorate (C-Note 24-02)[2] to contracting officers containing similar guidance for determining whether a contractor's unilateral CAP change has or will result in payment of increased costs, in the aggregate, by the government. These Department of Defense (DoD) publications, the October 3 MRD and the October 3 C-Note (collectively referred to as "DoD guidance" herein), illustrate several scenarios to provide guidance to auditors and contracting officers regarding the extent to which unilateral CAP changes result in increased costs in the aggregate.

Based on the relevant Cost Accounting Standards (CAS) and Federal Acquisition Regulation (FAR) provisions, the similar approaches used by DCAA and DCMA in determining increased costs in the aggregate deviate from the rules allowing offsets resulting from higher costs allocated to fixed price contracts. Importantly, neither DCAA nor DCMA offers clear guidance on how to protect the

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[1] Defense Contract Audit Agency, Memorandum for Regional Directors, 23-PAC-009(R), *Revised Audit Guidance on the Cost Impact Calculation for a Unilateral Cost Accounting Practice Change*, October 3, 2023 (available at https://www.dcaa.mil/Portals/88/Documents/Guidance/MRDs/23-PAC-009(R)%20Cost%20Impact%20for%20Unilateral%20CAP%20Change.pdf?ver=LV78baW7hzQOMHQ_-0nXQg%3D%3D).

[2] Defense Contract Management Agency, Contracts Executive Directorate, C-Note 24-02, *Determining Increased Cost to the Government, In the Aggregate, Due to a Unilateral Cost Accounting Practice Change*, October 3, 2023.

government from the payment of increased costs in the aggregate. Depending on how the government follows this DoD guidance, it may seek recovery of more than increased costs in the aggregate or downward contract price adjustments when increased costs in the aggregate have not been, or will not be, paid.

Government contractors should be aware of the DoD guidance and be prepared to defend against inappropriate price adjustments that apply this guidance in lieu of relevant CAS and FAR rules.

Summary of DoD Guidance

According to FAR 30.603-2(a)(1), contractors may unilaterally change their disclosed or established CAPs. However, FAR 30.603-2(a)(2) and 48 CFR 9903.201-6(b) stipulate that the government will not pay increased costs in the aggregate as a result of the unilateral CAP change.

Based on the relevant Cost Accounting Standards (CAS) and Federal Acquisition Regulation (FAR) provisions, the similar approaches used by DCAA and DCMA in determining increased costs in the aggregate deviate from the rules allowing offsets resulting from higher costs allocated to fixed price contracts.

DCAA and DCMA identify four separate unilateral CAP change scenarios and provide guidance on how to calculate the increased cost to the government in the aggregate. Some of the data from the table in DCAA's October 3, 2023 MRD appears below.[3] Broadly, the DoD guidance instructs auditors and contracting officers not to simply add together the impacts for all fixed price and flexibly priced contracts, but rather to assess the nature of the unilateral CAP changes (i.e., an evaluation that represents more than just a mathematical exercise).

	Change in ETC[a] Cost Accumulation	Increased/(Decreased) Cost (FAR 30.604(h)(3)(i)–(iii))	Increased Cost in the Aggregate
Scenario 1	Increased ETC on Flex, Decreased ETC on Fixed	Increased Cost on Flex and Fixed	Increased cost to the government is calculated by combining across contract/subcontract groups, less duplicated cost due to cost shifts
Scenario 2	Increased ETC on Flex and Fixed	Increased Cost on Flex, Decreased Cost on Fixed	Increased cost to the government on flexibly priced contracts/subcontracts

[3] The DoD guidance addresses the same four scenarios. Although the amounts used in the examples are different, DCAA and DCMA appear to reach the same conceptual conclusions.

Scenario 3	Decreased ETC on Flex and Fixed	Decreased Cost on Flex, Increased Cost on Fixed	Increased cost to the government is calculated by combining across contract/subcontract groups
Scenario 4	Decreased ETC on Flex, Increased ETC on Fixed	Decreased Cost on Flex and Fixed	None

[a] ETC, estimate to complete.

Our Takeaways from DoD Guidance

In terms of background, the only authoritative guidance for resolving unilateral CAP changes is found in 48 CFR 9903.201-6(b)(1). The CAS Board amended 48 CFR 9903.201-6, effective June 14, 2000, to provide guidance for determining price and cost adjustments for unilateral CAP changes (see 65 FR 37470):

> *...Contracting Officer shall make a finding that the contemplated contract price and cost adjustments will protect the United States from <u>payment</u> of increased costs, in the aggregate; <u>and that the net effect of the adjustments being made does not result in the recovery of more than the estimated amount of such increased costs</u>… (emphasis added)*

The guidance at 48 CFR 9903.201-6(b)(1) is the extent of the existing authoritative rules in CAS regarding price and cost adjustments for unilateral CAP changes, but it is not a detailed set of instructions. It allows the government to apply the price adjustment rules appropriately in the circumstances consistent with 48 CFR 9903.306, which recognizes that adjustments include both increased and decreased costs as follows:

> *An adjustment to the contract price…may not be required when a change in cost accounting practices or a failure to follow Standards or cost accounting practices is estimated to result in increased costs being paid under a particular contract by the United States. This circumstance may arise when a contractor is performing two or more covered contracts, and the change or failure affects all such contracts. The change or failure may increase the cost paid under one or more of the contracts, while decreasing the cost paid under one or more of the contracts. In such case, the Government will not require price adjustment for any increased costs paid by the United States, so long as the cost decreases under one or more contracts are at least equal to the increased cost under the other affected contracts.*

48 CFR 9903.201-6(b)(1) stipulates three steps that contracting officers must follow when determining whether to adjust the price of one or more contracts and how to process the adjustment(s):

A. Determine the amount of increased costs to the government, if any.
B. Determine the increased costs, if there is any, in the aggregate by calculating the net effect of the adjustments being made.
C. Protect the government from payment of the increased costs in the aggregate.

The only scenario illustrated by DCAA and DCMA that follows Steps A–C appropriately in accordance with 48 CFR 9903.201-6(b)(1) is Scenario 4. Scenarios 1 and 3 illustrate the proper application of Steps A and B; however, they fail to offer appropriate guidance in applying Step C.

Scenario 2 illustrates the proper application of Step A but fails to follow the CAS rules in applying Step B.

Although the DoD guidance may seem concerning, it is important to remember that it does not represent statutory or promulgated regulation (e.g., CAS and FAR). Nonetheless, the DoD guidance provides a valuable preview of DCAA's and DCMA's expected position when it comes to calculating increased costs in the aggregate resulting from unilateral CAP changes.

Scenarios 1 and 3:

Scenario 1.B: Increased Cost for BOTH Fixed Price & Flexibly Priced: Fixed > Flex[4]

Contract Group	ETC After Change	ETC Before Change	Change in ETC	Increased Cost to the Gov't.	Decreased Cost to the Gov't.	***Increased Cost in the Aggregate***[5]
Fixed Price – CAS-covered	$ 50	$ 100	$ (50)	$ 50	$ -	
Flexibly Priced – CAS-covered	125	100	25	25	-	
Non-CAS-covered	125	100	25	-	-	
Total	$ 300	$ 300	$ -	$ 75	$ -	***$ 50***

Scenario 3.B: Decreased Flexibly Priced Cost Less than Increased Fixed Price Cost[6]

Contract Group	ETC After Change	ETC Before Change	Change in ETC	Increased Cost to the Gov't.	Decreased Cost to the Gov't.	***Increased Cost in the Aggregate***
Fixed Price – CAS-covered	$ 50	$ 100	$ (50)	$ 50	$ -	
Flexibly Priced – CAS-covered	75	100	(25)	-	25	
Non-CAS-covered	175	100	75	-	-	
Total	$ 300	$ 300	$ -	$ 50	$ 25	***$ 25***

[4] Scenario 1.B represents an excerpt from DCAA's October 3, 2023 MRD. The MRD contains two other examples (Scenarios 1.A and 1.C) that contain slightly different fact patterns but are conceptually the same as Scenario 1.B. A similar example is provided in DCMA's October 3, 2023 C-Note (i.e., Illustration #1); however, the example values are different.

[5] Interestingly, certain table headers in the DCMA C-Note are labeled "Aggregate Increased Costs **Paid**" (emphasis added), but the header labels in the DCAA MRD are labeled "Increased Cost in the Aggregate."

[6] Scenario 3.B represents an excerpt from DCAA's October 3, 2023 MRD. The MRD contains two other examples (Scenarios 3.A and 3.C). Scenario 3.C contains a slightly different fact pattern from Scenario 3.B but is conceptually the same. Scenario 3.A contains a different fact pattern from Scenarios 3.B and 3.C, most notably showing no increased costs in the aggregate. Consequently, we did not identify the same concerns in Scenario 3.A as we did in Scenarios 3.B and 3.C. DCMA's October 3, 2023 C-Note contains an example (i.e., Illustration #3) that is similar to DCAA's Scenarios 3.B and 3.C; however, the example values are different.

Scenarios 1.B and 3.B illustrate a proper determination of increased costs (Step A) and increased costs in the aggregate (Step B) in accordance with 48 CFR 9903.201-6(b)(1). Increased costs are calculated as either higher costs allocated to flexibly priced contracts or lower costs allocated to fixed price contracts. Increased costs in the aggregate are calculated by netting the cost increases with the cost decreases.[7] However, in applying Step C, the guidance is to obtain a price adjustment to protect the government from payment of increased costs in the aggregate. The DoD guidance fails to explain why the recommended price adjustment is necessary. The circumstances indicate that the government is already protected from payment of increased costs by the amount of higher costs allocated to non-CAS-covered contracts. Because the government will not pay the higher costs allocated to non-CAS-covered contracts, there is no need to adjust CAS-covered contracts for these amounts. In Scenario 1.B, showing increased costs in aggregate of $50, the government is protected from payment of $25 of higher costs allocated to non-CAS-covered contracts. Therefore, the only price adjustment needed is to limit the costs allocated to flexibly priced contracts by $25. In Scenario 3.B, showing increased costs in the aggregate of $25, the government is already protected from payment of $25 because non-CAS-covered contracts were allocated $25 of higher costs (note that, in total, $75 of higher costs were allocated to non-CAS covered-contracts). Therefore, no price adjustment is needed. The government could request a written agreement from the contractor to ensure the higher costs were allocated to non-CAS-covered contracts.

Government contractors should be aware of the DoD guidance and be prepared to defend against inappropriate price adjustments that apply this guidance in lieu of relevant CAS and FAR rules.

Scenario 2:

Scenario 2.A: Decreased Fixed Price Cost & Increased Flexibly Priced Cost: Same Value[8]

Contract Group	ETC After Change	ETC Before Change	Change in ETC	Increased Cost to the Gov't.	Decreased Cost to the Gov't.	***Increased Cost in the Aggregate***
Fixed Price – CAS-covered	$ 125	$ 100	$ 25	$ -	$ 25	
Flexibly Priced – CAS-covered	125	100	25	25	-	
Non-CAS-covered	50	100	(50)	-	-	
Total	$ 300	$ 300	$ -	$ 25	$ 25	***$ 25***

Scenario 2.A illustrates a proper determination of increased costs (Step A). However, increased costs in the aggregate are not properly determined in accordance with CAS. Under Step B, increased costs need to be offset against decreased costs. There is no exception in CAS justifying the exclusion of decreased costs on fixed price contracts for purposes of determining the net effect of the change.

[7] Although Scenario 1 in DCAA's October 3, 2023 MRD directly addresses *Raytheon Co., Space & Airborne Sys.*, ASBCA No. 57801, 15-1 BCA ¶ 36, 024 and offers guidance that limits the government's ability to recover amounts that could exceed increased costs in the aggregate resulting from unilateral CAP changes, it fails to address whether the increased costs were paid or will be paid by the government. This scenario prevents the government from recovering amounts that could exceed increased costs in the aggregate resulting from a combination of increased ETCs on flexibly priced contracts and decreased ETCs on fixed price contracts.

[8] Scenario 2.A represents an excerpt from DCAA's October 3, 2023 MRD. The MRD contains two other examples (Scenarios 2.B and 2.C) that contain slightly different fact patterns but are conceptually the same as Scenario 2.A. A similar example is provided in DCMA's October 3, 2023 C-Note (i.e., Illustration #2); however, the example values are different.

Therefore, the increased costs in the aggregate are zero, and there is no need to adjust contract prices. By following the guidance for Scenario 2.A, the government would recover $25 more than increased costs in the aggregate of zero.

In addition to the apparent conflict with 48 CFR 9903.201-6(b)(1), Scenario 2 in DCAA's October 3, 2023 MRD also appears to conflict with FAR 30.603-2(a)(2)(ii), which states the following regarding unilateral CAP changes:

> *The net effect of the contemplated adjustments <u>will not result in the recovery of more than the increased costs to the Government, in the aggregate.</u> (emphasis added)*

When it comes to defining the component pieces of the aggregate cost increase calculation for unilateral CAP changes, FAR 30.604 is clear in stating that the government experiences a decrease in cost resulting from increased ETCs on fixed price contracts:

> *(ii) <u>Determine the increased or decreased cost to the Government for fixed-price contracts and subcontracts as follows:</u>*
>
> > *(A) When the estimated cost to complete using the changed practice is less than the estimated cost to complete using the current practice, the difference is increased cost to the Government.*
> >
> > *(B) <u>When the estimated cost to complete using the changed practice exceeds the estimated cost to complete using the current practice, the difference is decreased cost to the Government. (emphasis added)</u>*
>
> *…*
>
> *(iv) Calculate the increased cost to the Government in the aggregate.*

Ultimately, DCAA's October 3, 2023 MRD recognizes that the government is harmed when ETCs decrease on fixed price contracts resulting from a unilateral CAP change (i.e., Scenario 3); however, the DoD guidance appears to disregard the benefit received by the government on fixed price contracts when the ETC increases (i.e., Scenario 2). Specifically, the DoD guidance directs the government to disregard certain decreased costs in determining the net effect of increased and decreased costs. Therefore, Scenario 2 in DCAA's October 3, 2023 MRD runs counter to the second step of the guidance (i.e., Step B) within 48 CFR 9903.201-6(b)(1) (i.e., calculating increased costs in the aggregate).

Broadly, the DoD guidance instructs auditors and contracting officers not to simply add together the impacts for all fixed price and flexibly priced contracts, but rather to assess the nature of the unilateral CAP changes (i.e., an evaluation that represents more than just a mathematical exercise).

Scenario 4:

Scenario 4: Decreased Flexibly Priced Cost and Decreased Fixed Price Cost[9]

Contract Group	ETC After Change	ETC Before Change	Change in ETC	Increased Cost to the Gov't.	Decreased Cost to the Gov't.	***Increased Cost in the Aggregate***
Fixed Price – CAS-covered	$ 125	$ 100	$ 25	$ -	$ 25	
Flexibly Priced – CAS-covered	75	100	(25)	-	25	
Non-CAS-covered	100	100	-	-	-	
Total	$ 300	$ 300	$ -	$ -	$ 50	***$ -***

Scenario 4 in DCAA's October 3, 2023 MRD appears to be consistent with requirements set forth in 48 CFR 9903.201-6(b)(1). Under Step A, there is no increased costs to the government. Therefore, there are no increased costs in the aggregate or a need to adjust contract prices.

What Does This Mean for Your Organization?

Although the DoD guidance may seem concerning, it is important to remember that it does not represent statutory or promulgated regulation (e.g., CAS and FAR). Nonetheless, the DoD guidance provides a valuable preview of DCAA's and DCMA's expected position when it comes to calculating increased costs in the aggregate resulting from unilateral CAP changes. To the extent that the DoD guidance is neither modified nor rescinded,[10] we would expect DCAA and DCMA to evaluate unilateral CAP changes according to the guidance set forth therein.

Because the guidance in Scenarios 1–3 in DCAA's October 3, 2023 MRD appears to conflict with current statutory regulation, government contractors should be ready to prepare unilateral CAP change cost impact analyses using applicable CAS and FAR rules and to defend their position accordingly. Government contractors should consider consultation with industry experts, including accounting and legal professionals, before submitting unilateral CAP change cost impact analyses that align with Scenarios 1, 2, or 3 facts and circumstances.

[9] Scenario 4 represents an excerpt from DCAA's October 3, 2023 MRD. A similar example is provided in DCMA's October 3, 2023 C-Note (i.e., Illustration #4); however, the example values are different.
[10] As of April 4, 2024, we are not aware of DCAA or DCMA rescinding or modifying their October 3 guidance.

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