

ADVISORY

June 2010

## Federal Circuit Affirms ASBCA Decision Interpreting the Definition of an ‘Affected CAS-Covered Contract’

On June 10, 2010, the United States Court of Appeals for the Federal Circuit issued a decision regarding the interpretation of the Federal Acquisition Regulation (FAR) definition of an “affected Cost Accounting Standard (CAS)-covered contract.” *Donley v. Lockheed Martin Corp.*, --- F.3d ----, doc. no. 2009-1261 (Fed. Cir. Jun. 10, 2010). The court upheld the decision of the Armed Services Board of Contract Appeals (ASBCA), which ruled in favor of Lockheed Martin .

The need to clarify the concept of an affected CAS-covered contract or subcontract is critical in the event that a contractor is required to agree to a contract price/cost adjustment under the CAS clause of the FAR. That regulation requires a contractor to agree to such an adjustment if the contractor fails to follow its cost accounting practices in accumulating and reporting costs, makes a change to its cost accounting practices, or fails to comply with an applicable CAS, and thereby causes increased costs to the government. FAR 52.230-2(a)(2), (a)(5). Only affected CAS-covered contracts and subcontracts are considered in determining the cost impact of a change in cost accounting practice or CAS noncompliance. FAR 30.604(h)(1), 30.605(h)(1).

The term “affected CAS-covered contract or subcontract” was not expressly defined until the FAR Part 30 rewrite in 2005, when the definition was added to the definitions for the CAS Administration at FAR 30.001 and to the definitions for the Administration of CAS at 52.230-6(a). The definition provides:

*Affected CAS-covered contract or subcontract* means a contract or subcontract subject to Cost Accounting Standards (CAS) rules and regulations for which a contractor or subcontractor—

- (1) Used one cost accounting practice to estimate costs and a changed cost accounting practice to accumulate and report costs under the contract or subcontract; or
- (2) Used a noncompliant practice for purposes of estimating or accumulating and reporting costs under the contract or subcontract.

The Federal Circuit affirmed the decision of the ASBCA that a Lockheed Martin contract with the Air Force for the development of F-22 fighter aircraft was *not* an affected CAS-covered contract, and therefore was not subject to a contract price adjustment under FAR 52.230-2(a) due to Lockheed Martin’s changed

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accounting practices. *Appeal of Lockheed Martin Corp.*, ASBCA No. 53822, 07-2 BCA ¶ 33,614. The Federal Circuit, like the ASBCA, found that all costs under the F-22 contract had been estimated and reported under the same accounting practices, and thus the F-22 contract could not be considered an affected CAS-covered contract.<sup>1</sup>

The Federal Circuit clarified that the “critical inquiry” in determining whether a contract is an affected CAS-covered contract is “whether costs were estimated under one accounting practice but reported under another.” In doing so, the court recognized that the 2005 definition of an “affected contract” post-dated the F-22 contract, but agreed with the ASBCA that “the principles underlying the 2005 definition, e.g., requiring the accounting change to be the cause of the additional costs, were already implicit in the relevant regulations at the time of the 1992-93 contract modification.” Slip op. at 9.

The Air Force claimed that it was entitled to an adjustment because Lockheed Martin made a change to its accounting practices during performance of the contract that caused the government to pay increased costs. The Federal Circuit rejected this argument, finding that the Air Force had in fact repriced the F-22 contract in order to ensure that the cost of the program remained within the Air Force’s budgetary constraints. In so doing, the Air Force used the increased costs resulting from the changed accounting practices, not the costs originally used to estimate costs prior to the change. The Federal Circuit found that “substantial evidence” supported the conclusion that the Air Force was aware of the changed accounting practices and used the increased costs to estimate the cost of the F-22 program: (1) Lockheed Martin disclosed, in specific detail, the cost of the accounting changes to the Air Force during negotiations; (2) the Divisional Administrative Contracting Officer used Lockheed Martin’s new accounting practices to calculate forward pricing rates, which were used to negotiate the new cost estimate;

and (3) a representative of the Air Force negotiating team acknowledged that “it was our intent to incorporate the impact of the accounting changes, as they impacted the F-22, in our negotiations, and we believe we did so.”

Because the Air Force used the increased costs resulting from the changed accounting practices to reprice the F-22 contract, there was no inconsistency between the manner in which costs had been estimated and subsequently reported. Costs incurred prior to the contract modification were estimated and reported in a consistent manner, and costs incurred after the contract modification were estimated and reported in a consistent (albeit changed) manner. As the Federal Circuit explained, “We agree with the Board that a contract is not ‘affected’ when each contract cost is estimated and reported using the same accounting method, even if some costs are estimated and reported using one accounting practice and other costs are estimated and reported using a different practice.”

A contractor can satisfy the Federal Circuit’s “critical inquiry” test for identifying an affected CAS-covered contract by demonstrating that each estimated contract cost was subsequently reported under the same accounting practices. Thus, even where the contractor changes its accounting practices or has a CAS noncompliance that results in increased costs to the government, a contract price/cost adjustment may not be inevitable.

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*We hope that you find this advisory helpful. If you would like more information on this or other government contract issues please feel free to contact:*

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<sup>1</sup> More particularly, the contract at issue involved a definitized contract modification to re-phase the F-22 contract. Lockheed Martin’s General Order of Magnitude cost impact proposal estimated increased costs of approximately US\$10 million due to the change in accounting practice, but did not include the F-22 contract as an affected contract.