We have written several articles covering acquisitions of commercial items. This will be another! But if you are unfamiliar with commercial item contracting, please don't start with this one. Instead, go to the site search feature (which is on the upper right corner of the home page), or else use the "Title Filter" on the top of the News Archive page, and search using the term "commercial". You should see about four or five worthy starting points.

We have written several articles covering our concerns about the tendency of DCAA and DCMA to "push around" small businesses. This will be another! Again, there are three or four worthy articles that provide background and anecdotal evidence supporting our concerns in this area.

We have written a few articles covering the challenges faced by contractors seeking to properly value inter-organizational transfers (aka intercompany transfers, aka inter-divisional transfers, aka intracompany transactions, aka inter-company subcontracts—which we will simply acronymize as "IOTs"). This will be another! Here's **a link** to a good starting point. In another brief article (posted in 2010), we noted that Bell Textron had resolved allegations of violations of the False Claims Act related to the pricing of its IOTs by agreeing to pay the U.S. Government some $16.6 million.

With all that as background, let's assert a few opinions right off the bat.

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The Department of Defense has difficulty in dealing with commercial item determinations (CIDs). It has difficulty in accepting a contractor's CID. It has difficulty accepting the lack of cost or pricing data that is part and parcel of commercial item contracting, since by definition the price is established by the marketplace. It has difficulty in accepting the profit inherent in commercial items. DoD COs, as a rule, just plain don't like commercial items. (As Vern Edwards recently posted on the WIFCON forum: "Most of the problems with commercial item assertions have arisen in connection with DOD purchases of spare parts. … The main difficulty is COs who feel they must apply a 'beyond a reasonable doubt' standard when making their commerciality determinations in order to avoid criticism. This is yet another reason why DOD needs its own acquisition regulation, if for no other reason than to free everybody else from the insanity of its [own] processes.") In an attempt to stop "the insanity" DoD has recently created six Commercial Item Centers of Excellence to "advise Procuring Contracting Officers (PCOs) in their determinations of commerciality."

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Congress is aware of DoD's difficulties in this area. The 2017 National Defense Authorization Act contained an entire Subsection F, with multiple provisions intended to help DoD in its struggles with commercial items.

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DCAA has even more trouble dealing with commercial items than the COs do. They don't like commercial items because there's nothing to audit. About the only thing an auditor can do is to assert that a commercial item price is unreasonable—which is crazy if you think about it, because by definition the price paid in the free and open market is *the essence* of price reasonableness.

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We have seen (and written about) DCAA's propensity for asserting that a contractor's accounting system is inadequate when a contractor has the temerity to disagree with a DCAA position. It's the biggest club DCAA has and, even if there are no payment withholds associated with the system inadequacy determination, the fact is that it is a body blow to the reputation and competitive position of a contractor. For a small business that is desperate for new contract awards, it may well be the action that puts that company out of business for good. The only defense to a DCAA attempt to run roughshod over a contractor is the "independent business judgment" of a CO; and that is a hit-or-miss proposition (at best). There seems to be no consequences to any Government party for a determination that a contractor's accounting system is inadequate, even if it is later shown to have been a egregiously wrong determination without any rational basis whatsoever. That's a shame, in our view.

Okay. At this point, you may well be asking, "where in the heck is this article going?" We have an answer: It's going **here** .

“Here” is a link to an ASBCA decision, published 8 February 2017, in the appeal of A-T Solutions, Inc. (We are happy to report that the ASBCA website seems to have come back from the Error 403 land of the dead.) The decision was written by Judge O’Sullivan on behalf of the Board. ATS was represented by the firm Crowell & Moring, who said of the decision, “in rare litigation over the pricing of items transferred between a contractor’s commonly controlled subdivisions, C&M successfully appealed a Contracting Officer’s refusal to pay commercial prices for materials a contractor had transferred between its business units.”

As you can see from that one sentence summary, the Board’s decision involved commercial items, IOTs, and a CO’s decision that IOT’s valued at price, based on a CID, were unreasonable. What you didn’t see (but will!) is that ATS was a small business that was being unjustly pushed around by DCAA and, rather than stand up for the company, the cognizant CO simply rubber stamped the DCAA audit findings (which included a finding that the accounting system was inadequate because the company refused to agree that it’s commercial item IOTs should be valued at cost). Pretty much everything we recited above is found in this one decision.

You ready to dig into it? Good.

In 2009 ATS was awarded a contract to provide training for armed forces to help them defeat the threat of Improvised Explosive Devices (IEDs). The contract type was cost-plus-fixed-fee (CPFF). It was to be awarded on a competitive basis. (Four proposals were received.) ATS was the incumbent contractor, previously having been awarded a firm, fixed-price on a sole source basis as well as a follow-on firm, fixed-price contract on a competitive basis. It was the successful bidder once again, being the low bidder while receiving top technical scores

In the prior contracts, “ATS provided its training materials and equipment as commercial items and was paid for them at its catalog prices.” Its proposal for the cost-type contract was summarized by Judge O’Sullivan as follows:

ATS proposed to bill direct labor, consultants, and subcontractors at cost plus a fixed fee calculated at 9% of estimated cost. ATS proposed to bill travel at cost (no fee). ATS proposed to charge for its commercial item training materials and equipment at the catalog prices attached to the proposal … Finally, consumable items bought locally would be billed at incurred cost (no fee).

ATS' proposed price was accepted by the government "without further negotiations," based on the price analysis performed as well as the cost realism analysis, and the finding that its price was "realistic, fair and reasonable."

Starting in October 2009, ATS began to invoice for training materials and equipment at its catalog prices. The invoices were paid "promptly and in full." This all changed when, a few months later, DCAA showed up at the small business to conduct an audit of "contract costs." As Judge O'Sullivan wrote, "Because DCAA did not accept ATS's position that it need not provide cost information for items that had been proposed and accepted at price, and the Army deferred to DCAA, ATS suspended its billing for the training materials and equipment in February of 2010 …" That was the first injustice done to ATS. DCAA's position that it had magical access into commercial item costs, instead of simply accepting the catalog pricing as a given, led to a decision by ATS to forego a significant portion of its due cash flow—potentially crippling the small business. It would not be the last injustice.

Note that the Army "deferred to DCAA" instead of exercising independent business judgment as required. It would not be the last deferral and refusal to exercise independent business judgment.

The DCAA audit report was damning. It stated—

In our opinion, ATS' accounting system is inadequate for accumulating and billing costs under Government contracts. Our examination disclosed a significant deficiency that is considered to be a material weakness in the design or operation of the accounting system. We determined the contractor is not currently billing material at cost as required under a cost reimbursable contract. In our judgment, this deficiency could adversely affect the organization's ability to initiate, authorize, record, process, and/ or report costs in a manner that is consistent with applicable Government contract laws and regulations. As a result, we recommend you pursue suspension of a percentage of reimbursement of costs in accordance with DFARS 242.7502.

We determined ... the contractor is billing costs associated with its training aids at catalog price rather than at actual unit cost. During discussions with [the] chief financial officer, we determined the contractor is continuing a practice started under the original firm-fixed-price contract. However, the contractor's current contract, which began in late 2009, is

cost-plus-fixed-fee. Cost reimbursable type contracts require materials to be tracked and billed at the base cost level, unless otherwise stated in the subject contract.

Let's stop right there and review the bidding. ATS had established the commerciality of its training aids and that commerciality had been accepted by the government. ATS had established a cost accounting practice of transferring those items at price, rather than at cost, in its previous contracts. ATS had proposed those items at price and expressly called attention to its practice in its proposal, which had been accepted without further negotiation or discussion, because the price was obviously fair and reasonable.

Now DCAA was expressing the opinion that the CPFF contract type required ATS to change its established cost accounting practices. DCAA was expressing the opinion that ATS was required to account for costs in a manner different than it had proposed them. DCAA was expressing the opinion that government acceptance of the commerciality of the costs and acceptance of the resulting price somehow didn't matter anymore.

We are at a loss to understand where in existing audit guidance those positions came from. We are fairly sure there's nothing anywhere that would have supported those positions. We are confident that any reasonable supervisory or higher level review would have noted that the position(s) were untenable and based on nothing more than *legal conclusions* regarding how commercial item accounting was supposed to work. There is nothing in the quoted pieces, above, that support the notion that the audit report was compliant with Generally Accepted Government Audit Standards (GAGAS).

Yet DCAA issued that adverse audit report anyway.

In the spirit of fairness, we have to tell you that DCAA did have one piece of evidence. The auditors had a report from ATS' Deltek CostPoint accounting system that showed the inter-organizational transfer at cost. However, had the auditors' done a lick more of work, they would have seen that the report had been issued at the enterprise level—i.e., including consolidation and elimination of intercompany profit as required by Generally Accepted Accounting Principles (GAAP). But the auditors were satisfied that their single report—a report that they had wrongly interpreted—was sufficient evidence to support their legal theory. And no amount of protestation from ATS was going to change their minds. (Which is another GAGAS violation, but whatever.)

As noted, DCAA not only refused to listen to ATS' arguments, it told ATS (and the contracting officer) that ATS "would have to prove it was capable of accumulating costs on the JATAC contract to prevent its accounting system from being found inadequate. … ATS thereafter, in order to avoid an adverse determination of inadequacy, submitted a 'Corrective Action Plan' to provisionally bill its products at fully burdened cost until the dispute could be resolved." In other words, the price for disagreeing with DCAA's legal theory was an inadequate accounting system. If this weren't the government, we would be throwing around words like "extortion" and "bad faith" and "fraud in the inducement" but, of course, this is the government so Hanlon's Razor applies. (Look up that reference.)

And where was the contracting officer in this Charlie Foxtrot? Nowhere to be found.

In March, 2014, ATS submitted a certified claim to the CO, asking for the $9.8 million that it had wrongfully withheld from the small business. It was denied. The CO—

... observed that using catalog pricing 'to support a proposed estimated cost in a competitive acquisition' was 'appropriate' but would not influence 'how payments are actually disbursed on a CPFF contract.' She also found the commerciality of the materials not relevant, since the government's requirement 'as a whole' was non-commercial. While commercial materials could be provided under the contract, she stated, ATS's accounting for the cost of materials must conform to the cost principles and procedures of FAR Part 31 and the terms of the cost-type contract.

The CO also agreed with DCAA that the IOTs of the commercial items had been made at cost, not price—as well as using "the misimpression" that "DCAA had 'determined ATS's accounting system [to be] inadequate' to meet the FAR requirement for billing at price" as additional justification for the denial.

Calling that a "misimpression" was a kindness on Judge O'Sullivan's part. In our view, it betrays a complete misunderstanding of so many things that we think the CO should have her warrant pulled. First, DCAA does not get to make determinations of accounting system adequacy—that's the CO's job. The fact that she didn't get that speaks volumes to her level of knowledge and expertise. Second, an accounting system is either adequate or it's not. There's no "adequate for this but not that" in this area. It was a fact that DCMA had found ATS'

accounting system to be adequate (because it had caved to DCAA's legal position)—and that was all that mattered. The CO seemed to have forgotten that "adequate means adequate" in her haste to support her COFD.

As Judge O'Sullivan wrote for the Board, FAR 31.205-26(e) provides an exception to the normal requirement that IOTs must be based on cost. IOTs may be based on price "when (1) it 'is the established practice of the transferring organization to price interorganizational transfers at other than cost for commercial work of the contractor or any division, subsidiary or affiliate of the contractor under a common control'; (2) the item being transferred qualifies for an exception to the requirement to submit cost or pricing data under FAR 15.403-l(b); and (3) the contracting officer has not determined the price to be unreasonable." In this case, the government conceded that ATS met requirements (2) and (3) but argued that it didn't meet the first requirement.

The government advanced two theories supporting its argument that ATS didn't meet the first requirement. "First, because ATS's transfers of training materials … lacked 'economic substance' and therefore do not qualify as transfers within the meaning of the relevant cost principle. Second, because even if the transfers qualify as such under the cost principle, the transfers were at cost, not price."

Judge O'Sullivan quickly disposed of the first "economic substance" theory, writing—

… the cost principle does not impose a requirement that the transfers in question have 'economic substance,' and the government's support for urging us to adopt such a test is thin: a bare citation to a section of a cost accounting treatise that purportedly lists examples of interorganizational transfers (neither the text of the treatise nor the context was supplied to the Board) and a citation to a Cost Accounting Standards regulation that addresses when transfers between affiliates will be deemed 'subcontracts' for purposes of CAS coverage. We decline the government's invitation to read an 'economic substance' requirement into the cost principle at issue. The government has failed to establish the existence of such a requirement or to suggest how a court or Board could tell if it had been met in a particular case.

(We note that Judge O'Sullivan could have also mentioned that the government's reference to CAS was inapposite, since ATS was a small business and therefore exempt from CAS coverage.)

Judge O'Sullivan wrote further—

The fact that training materials never left the Logistics and Production division at anything other than price, and that there were valid business reasons for crediting that division with a sale at commercial price whether the transaction was external or internal, carries great weight. Additionally, we do not see how the accounts receivable amount for sales of training materials could be posted to the Training division account rather than the Logistics and Production account if there had not been a transfer of the materials. *That the transfer may be essentially pass-through in nature does not prevent its recognition.*

The government's argument that the transfers were recorded at cost rests on the proposition that any transfer between divisions would have had to take place before ATS sold the materials and issued the invoice, but since the first and only time the transaction is recorded at price is when the sale is made to the customer, ipso facto, if a prior transfer occurred at all, it must have occurred at cost. The government produced no evidence or law in support of this proposition. To the contrary, the United States Court of Appeals for the Federal Circuit has recognized in its United Technologies decision that more than one valid transaction may take place simultaneously, and ATS has produced credible evidence that such transfers were recorded by the transferring division at commercial catalog price.

(Emphasis added. Internal citations omitted.)

So there you have it.

Literally eight years after contract award, ATS was permitted to bill its commercial item IOTs in the way it had consistently accounted for them, in the way it had proposed them, and in the way that the government had accepted when it agreed on the contract price.

Our opinion of the government's actions in this fiasco have not exactly been hidden. The role of a DCAA auditor to render an impartial and independent opinion has been called into question. The role of the DCAA supervisory auditor and higher-level reviewers, who allegedly ensure that the audit report complies with GAGAS, has been called into question. The role of

the contracting officer, who is not supposed to defer to DCAA but, instead, to render an impartial decision using independent business judgment, has been called into question. Nobody on the government's side has been covered with glory, in our view.

And what of ATS, that small business who kept on providing important training services to the warfighter while being denied a significant amount of cash flow it could have used to support its operations? That company who patiently pointed out DCAA's errors until faced with a Draconian penalty for failing to cave in? In our view, that company seems to be the only entity in this story that did the right thing for the right reasons. In a perfect world, DCAA Director Bales and DCMA Director Lt. Gen. Masiello would proffer written apologies to ATS and subject their employees to disciplinary action.

But the world of government contracting is far from perfect, isn't it?