A recent discussion thread on LinkedIn concerned the timing of the adjustment of provisional billing rates on cost-reimbursement contract types. This is an important topic for a number of reasons, including managing cash flow and complying with regulatory requirements. In our experience, it's a topic that a lot of people have trouble with, so we thought it would be a good topic for a blog article.

The LinkedIn posters generally agreed that billing rates could be adjusted after year-end (when the books closed) and again after the contractor's final indirect rates were certified and submitted for audit (generally, six months later). These positions were consistent with our understanding of the regulations (*e.g.*, FAR 42.7). But there was less consensus regarding the timing of adjusting provisional billing rates as the work was performed, during the contractor's fiscal year. So that's what we are going to focus on here.

Before we get too deep into the discussion, let's review the requirements of the FAR contract clause 52.216-7 ("Allowable Cost and Payment"). It's a mandatory contract clause on flexibly priced contracts, meaning that it must be included in any such contract. If you have a cost-reimbursement type contract, it's almost 100% certain that you have the Allowable Cost and Payment Clause in it, and therefore you have a lot of requirements to comply with. It's a critical clause to understand, and (unfortunately) it's also a long and complex clause. But we want to deal with just one specific part of it today because it establishes the regulatory requirements regarding how to set provisional billing rates and when to adjust them during contract performance. Here's the pertinent quote from 52.216-7:

(e) *Billing rates*. Until final annual indirect cost rates are established for any period, the Government shall reimburse the Contractor at billing rates established by the Contracting Officer or by an authorized representative (the cognizant auditor), subject to adjustment when the final rates are established. These billing rates—

(1) Shall be the anticipated final rates; and

(2) May be prospectively or retroactively revised by mutual agreement, at either party's request, to prevent substantial overpayment or underpayment.

So that portion tells us that the provisional billing rates "shall be" the anticipated final rates for the year, and that either party "may" request that the provisional rates be adjusted during

performance to better anticipate the final rates, in order "to prevent substantial overpayment or underpayment." In other words, whenever the contractor knows that its provisional billing rates are varying, to a significant degree, from its currently anticipated final indirect rates for the year, it should request an appropriate adjustment. If the contracting officer declines to adjust the billing rates, then s/he needs to be able to justify why not—since the clause *mandates* that the provisional billing rates "shall be" the anticipated final rates. Bottom-line: while there may be some discretion with respect to notification, there is no discretion once notification has been made—the billing rates
*must*
be adjusted.

That's how we parse the requirements, in any event.

In the case where a contractor's provisional billing rates are running *higher* than it expects to see at year-end, there is usually very little discussion. If the billing rate is set at 100% and the contractor requests it be lowered to 90%, the customer is almost always happy to pay less. However, where a contractor's billing rates are running
*lower*
than it expects to see at year end—meaning that the rates should be increased so as to avoid a substantial underpayment—then our experience has been that the customer is more than somewhat reluctant to increase the billing rates. For example, if the billing rate is set at 90% and the contractor requests it be increased to 100%, then the customer typically is loath to take action, since doing so will burn funding that much faster. In such cases, see the paragraph above and discuss with the customer the use of the word "
*shall*
" and what the imperative tense means in government contracting. (Hint: See FAR 2.101, Definitions.)

What about the situation where a contractor knows (or should know) that its provisional billing rates are set too high and that they should be lowered so as to prevent a significant overpayment from being received from its government customer—but the contractor chooses *n ot*
to notify the contracting officer and request an adjustment? After all, a strict reading of 52.216-7(e), quoted above, seems to say that there is some discretion involved in choosing whether to submit a notification.

Contractors wishing to reap the increased cash flow associated with provisional billing rates that have been set higher than the contractor's anticipated final rates need to be aware of the

requirements associated with another mandatory contract clause—52.232-25 ("Prompt Payment"). Down at the bottom of the clause is this little gem—

(d) *Overpayments*. If the Contractor becomes aware of a duplicate contract financing or invoice payment *or that the Government has otherwise overpaid on a contract financing or invoice payment*, the Contractor shall—

(1) Remit the overpayment amount to the payment office cited in the contract along with a description of the overpayment including the—
(i) Circumstances of the overpayment (*e.g.*, duplicate payment, erroneous payment, liquidation errors, date(s) of overpayment);

(ii) Affected contract number and delivery order number if applicable;

(iii) Affected contract line item or subline item, if applicable; and

(iv) Contractor point of contact.

[Emphasis added.]

So the question becomes, if the provisional billing rates have been set higher than they should be, is the contractor generating an improper billing and thus receiving an overpayment for which it must refund the money and provide a description of the "circumstances of the overpayment"? The answer, provided by the FAR Councils, appears to be yes.

In October, 2003, Federal Acquisition Circular (FAC) 2001-16 implemented as a Final Rule FAR Case **2001-005** ("Notification of Overpayment, Contract Financing Payments"). In the promulgating comments, the FAR Council discussed overpayments and a commenter's concerns that certain routine contractual actions might be "misconstrued as overpayments because they may result in a need for the contractor to pay a sum back to the Government as a result of the normal and expected operation of contractual terms and conditions." The commenter recommended that the term "overpayment" be defined in the regulations, so as to prevent any misunderstandings between the contracting parties. The FAR Councils did not agree. Here's the comment and their response—

Comment: There is concern that credit invoices, due to a revision of indirect billing rates, contractual actions impacting negotiated price, adjustments to progress payments as a result of

change in the contract's estimated cost at completion, and authorized borrow-payback transfers will all be potentially misconstrued as overpayments because they may result in a need for the contractor to pay a sum back to the Government as a result of the normal and expected operation of contractual terms and conditions. Therefore, the following definition should be added at the beginning of each of the proposed paragraphs imposing a notification requirement:

An overpayment is a payment of an amount greater than the value the contractor is entitled to receive at the time of the payment.

Councils' response: Do not concur. The intent of the rule is to require contractors to notify the Government when they become aware that an incorrect payment has been made. The Councils do not believe there is a demonstrated need for such a definition. First, the term 'overpayment' is used in Government contracting in a variety of contexts, and we are concerned that establishing a definition in the payment clauses could have unintended consequences. Second, *when a contract is modified to reflect the incorporation of new billing rates, or some other contract administration action, the contract modification should identify whether a credit is due the Government.* The Councils do not anticipate that a contracting officer would issue a notification of overpayment in these instances. If, in the future, it becomes apparent that, in practice, contracting officers are taking an overly broad and needlessly burdensome interpretation of what constitutes an overpayment for the purposes of this notification requirement, then the Councils will revisit this issue.

[Emphasis added.]

So, based on the foregoing, the FAR Councils appeared to link provisional billing rate adjustments to making proper payments; thus, they may well have intended to link a failure to adjust billing rates (when required to make an adjustment) to "incorrect" or "improper" payments that would generate overpayments. It may well be the case that, any discretion found in 52.216-7(e) would be trumped by the mandatory language of 52.232-25(d).

While our interpretation is admittedly tenuous and based on some speculation, do you really want to take a chance that some auditor or contracting officer is going to accuse your company of making improper payments because you intentionally let the provisional billing rate be set too high, thus generating excess cash for your company?

The point is far from academic. Recently, the Department of Justice **announced** that **Calnet, Inc.** agreed to pay $18.1 million in order to resolve allegations that it had submitted false claims to

the Defense Department. Calnet's issue was that it allegedly "overstated its provisional overhead or indirect rates" on each of its three contracts to provide translation services for the DOD. The Government alleged that the overstated indirect rates created "inflated claims for payment"—
*i.e.*
, false claims.

The litigation was the result of a *qui tam* suit filed under the False Claims Act by a former Calnet employee (who will receive $2.7 million from the settlement). While we don't know many details of the allegation, we do know that the DOJ press release included the following statement—

'Contractors are expected to comply with their statutory obligations and act in good faith when dealing with the United States government,' said Stuart F. Delery, Acting Assistant Attorney General for the Department of Justice's Civil Division. 'We will not tolerate false statements and failure to disclose information that is important to the government's contracting processes.'

Again, we don't have the facts of the situation. But the quote above makes us think that Calnet was alleged to have knowingly failed to notify its contracting officer that its provisional billing rates needed to be adjusted downwards. That failure created incorrect invoices that allegedly amounted to false claims.

So this is an issue that can and will be taken seriously by Federal law enforcement officials. So we ask you again—is this an issue you want to take a chance on? We think not. Our advice is to periodically monitor indirect rates and compare year-to-date actuals and at-year-end forecasts with provisional billing rates; promptly notify the cognizant contracting officer if provisional rates should be adjusted downward (or upward).

One more thing before we leave this topic. What about making Disclosures in accordance with the requirements of the contract clause 52.203-13 ("Contractor Code of Business Ethics and Conduct")? That clause states (in part)—

(b)(3)(i) The Contractor shall timely disclose, in writing, to the agency Office of the Inspector General (OIG), with a copy to the Contracting Officer, whenever, in connection with the award, performance, or closeout of this contract or any subcontract thereunder, the Contractor has credible evidence that a principal, employee, agent, or subcontractor of the Contractor has committed—

(A) A violation of Federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations found in Title 18 of the United States Code; or

(B) A violation of the civil False Claims Act ( 31 U.S.C. 3729-3733 ).

In the LinkedIn discussion thread one poster wrote that, “One of my clients was recently threatened by DCAA with the sanctions of 52.203-13 saying that failure to revise rates that would result in over-recovery of indirect costs would constitute a ‘knowing failure to timely disclose’ an overpayment.”

There are a couple of things wrong with DCAA’s assertion. As the poster noted, the situation is not as black-and-white as DCAA would assert. The FAR regulations discussing the 52.203-13 clause state—

### 3.1003 Requirements.

(a) *Contractor requirements.*

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(2) Whether or not the clause at 52.203-13 is applicable, a contractor may be suspended and/or debarred for knowing failure by a principal to timely disclose to the Government, in connection with the award, performance, or closeout of a Government contract performed by the contractor or a subcontract awarded thereunder, credible evidence of a violation of Federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations found in Title 18 of the United States Code or a violation of the civil False Claims Act. Knowing failure to timely disclose credible evidence of any of the above violations remains a cause for suspension and/or debarment until 3 years after final payment on a contract (see 9.406-2 (b)(1)(vi) and 9.407-2 (a)(8)).

(3) The Payment clauses at FAR 52.212-4 (i)(5), 52.232-25 (d), 52.232-26 (c), and 52.232-27 (l) require that, if the contractor becomes aware that the Government has overpaid on a contract financing or invoice payment, the contractor shall remit the overpayment amount to the Government.

*A contractor may be suspended and/or debarred for knowing failure by a principal to timely disclose credible evidence of a significant overpayment, other than overpayments resulting from contract financing payments as defined in 32.001 (see 9.406-2 (b)(1)(vi) and 9.407-2 (a)(8)).*

[Emphasis added.]

Looking at FAR 32.001, we see the following definition of "contract financing payments"—

"Contract financing payment" means an authorized Government disbursement of monies to a contractor prior to acceptance of supplies or services by the Government.

(1) Contract financing payments include—
(i) Advance payments;

(ii) Performance-based payments;

(iii) Commercial advance and interim payments;

(iv) Progress payments based on cost under the clause at 52.232-16 , Progress Payments;

(v) Progress payments based on a percentage or stage of completion (see 32.102 (e)), except those made under the clause at 52.232-5 , Payments Under Fixed-Price Construction Contracts, or the clause at 52.232-10 , Payments Under Fixed-Price Architect-Engineer Contracts; and

*(vi) Interim payments under a cost reimbursement contract, except for a cost reimbursement contract for services when Alternate I of the clause at 52.232-25 , Prompt Payment, is used.*

(2) Contract financing payments do not include—
(i) Invoice payments;

(ii) Payments for partial deliveries; or

(iii) Lease and rental payments.

[Emphasis added.]

Based on the foregoing, it seems fairly clear that interim payments under cost reimbursement contract types cannot generate overpayments, *as that term is used by the 52.203-13 clause* (except for cost reimbursement contracts for services that use Alternate I of the 52.232-25 clause). Accordingly, it's unlikely that a contractor would be subject to suspension or debarment for submitting interim vouchers that included too-high provisional billing rates.

But remember that the FAR Councils deliberately avoided defining the term "overpayment," because that term was used "in a variety of contexts." So while it seems clear (to us) that such interim payments using provisional billing rates under cost reimbursement contracts cannot create overpayments for purposes of complying (or not complying) with the 52.203-13 requirements—and thus cannot create a situation where a contractor could be suspended or debarred—that's as far as we can go. As Calnet learned, such interim payments might create overpayments/false claims for purposes of complying with the False Claims Act.

As we noted twice before, is this something you really want to take a chance on?