Here's another one of those stories that offer an opportunity to learn from the mistakes of others. Of course, the entities that most need to learn the lessons won't do so because they don't read this blog. But for the rest of you, consider the mess that PHI Applied Physical Sciences, Inc. (PHI) has gotten itself into. *Don't do this.*

PHI received a SBIR Phase 2 contract—a cost-plus-fixed-fee contract—in May, 2005, to develop a "miniature fluorometer" for DARPA and to "demonstrate it at the DoD Small Business Innovation Research Program Phase II and Beyond Conference." That SBIR conference was to be held in July, 2005, a mere three months after contract award. After the conference, PHI had an additional three months to submit a "final technical report". Accordingly, the contract's period of performance ended in November, 2005. The contract value was $37,730. The value was based on $37,730 in estimated costs and zero fixed fee.

Based on the foregoing, you pretty much knew PHI was in trouble. The only way they were going to "develop" their gadget in time was to have it already developed. The $37,730 needed to cover travel and labor for the conference, as well as the labor needed to write the final technical report. And it also needed to cover employee fringe benefit costs associated with that labor, as well as any indirect costs associated with running the business that were going to be allocated to the contract. It's pretty obvious that $37,730 wasn't going to cover PHI's direct expenses, let alone any allocated indirect expenses. Yet that's the deal that PHI signed up for.

By early August, 2005—i.e., within 60 days after contract award—PHI had submitted its first two public vouchers in the aggregate amount of $36,184; DFAS paid those vouchers in September. And then DCMA asked DCAA (Santa Ana Branch, Western Region) to perform a post-award accounting system review. The record does not show why DCMA felt it necessary to spend taxpayer funds to ensure that the contractor had an accounting system adequate to handle a $38,000 contract, or why *anybody* would think that action to be a prudent use of taxpayer funds. Yet that's what DCMA requested, and that's what DCAA did, even though DCAA likely had more important things on its plate at the time. The DCAA auditor showed up at PHI's facility in September, 2005, to perform the post-award accounting system review.

Now we have had unkind words to say about DCAA in the past. We hope most of our umbrage has been directed at the top of the DCAA pyramid, and not at the individual auditors who are forced to carry out the questionable policy decisions made at Fort Belvoir. But we'd understand if the DCAA workforce felt we were biased against DCAA and in favor of contractors. So the following sentence may come as a bit of a surprise to some readers.

Based on the record, the Santa Ana Branch DCAA auditor was kind and reasonable, and clearly went out of her way to try to help this poor small business contractor who was in far over its head.

For example, the auditor reported back to the DCMA Contracting Specialist as follows—

Just need to let you know that PHI does not have[an accounting]system in place. I just met with them yesterday. The company has 3 direct people and 2 indirect people, and no experience with government contracting. They kept time sheets, but made no distinction between direct and indirect labor, had no idea how to set up their accounts, was not familiar with unallowable [cost], accrued labor but had not paid their employees (so there are no payroll records), did not keep track of their contract ceiling cost = 37K and did not segregate indirect expenses into logical groupings, such as Overhead and G&A. I had nothing to report back to you accounting and billing system wise except that they kept their records manually, on excel worksheets and folders. They just purchased peach tree [accounting software] but had not inputted their financial data into the system. There are indicators of financial distress.

Now in our experience, many auditors would have stopped right there and simply issued a Fraud Referral to the DoD IG. But this auditor seemed to really go out of her way to try to assist PHI with its many, many issues. She wrote to the DCMA Contracting Specialist—

In the meantime, they need to get an amendment raising the ceiling of the contract. They claimed they incurred in excess of $300,000 to create this prototype. You may want to send an audit request for incurred costs to date only. The only thing I can do for you is verify the material and subcontract costs to invoices and payment.

The DCAA sent a follow-up email to PHI, telling it that the government had no funds to increase the ceiling value. That didn't stop PHI from subsequently requesting a "no-cost" period of performance extension of an additional six months. The buying customer didn't want to do that. Instead, the government sought to revise the contract type from CPFF to firm, fixed-price. While this action would have undoubtedly benefited the contracting officer, it would have also undoubtedly benefited PHI as well, since it would be off the hook for the requirement to submit a proposal to establish final billing rates, or to support a DCAA audit of that proposal. It might have also reduced the company's exposure to allegations of violations of certain statutes, among them the False Claims Act.

We really cannot stomach the thought of telling you about how PHI responded to the situation. It was really that bad. Here's a sample of what the company wrote to DCMA—

We realize that your organization wishes to resolve this issue to the benefit of all parties; we share that goal. But any proposed solution must take into consideration our nation's security, as well as concepts of fundamental fairness. … The DCAA ordered us stop technical work. In fact, such work was not possible for many months because of the oral and written auditing requirements imposed upon us by three government agencies under the terms of the CPFF contract. Such administrative work is normal for such contracts, but we have not been compensated for any of the additional work.

PHI finally submitted its Final Technical Report along with Vouchers 3 and 4. Voucher 3 was in the amount of $36,591.59 for "Overhead on Public Vouchers 1 and 2," while Voucher 4 was in the amount of $243,443.44 for "payroll" and "overhead". Details as to how the values were calculated were lacking. Voucher 5 sought reimbursement of $40,000 associated with preparation of the Final Report. PHI also submitted a Form DD250 that sought reimbursement of Vouchers 1 through 4 plus added an additional $25,000 for "fixed fee". In sum, PHI sought payment in the amount of $343,035, some of which may have already been paid by DFAS.

In addition to the foregoing, PHI subsequently submitted Voucher 6 in the amount of $47,378 for "overhead on final report Voucher 5." The DCMA Contracting Officer was as helpful as the DCAA auditor had been: she encouraged PHI to submit a public voucher for the $1,546 difference between the contract value and the amounts previously paid by DFAS. The CO stated that PHI had failed to comply with the administrative requirements of the Limitation of Cost clause and thus no increase to the contract value would be forthcoming. Notably, no fraud referral was made.

Instead of counting its lucky stars, PHI filed an appeal of the deemed denial of its alleged claim for $1,276,904 in "cost overruns incurred in performance" of its $38,000 contract. The ASBCA decision can be found here .

The matter turned on whether PHI had complied with the Limitation of Cost (LOC) clause in its contract. The LOC clause is one of those pesky back-office administrative clauses that are incorporated by reference into Section I. You know, the list of clauses that nobody ever reads? Yeah. As we've asserted before (many times), those clauses are important and you ignore them at your own peril. PHI ignored the LOC clause, as it ignored pretty much every clause in its CPFF contract.

Regardless, PHI's attorney argued along the following lines—

Appellant primarily argues it was 'impossible' to give the 60-day notice because it had overrun the contract essentially from its inception. It also focuses on the actions and instructions of a government auditor arguing that the auditor impliedly authorized its incurrence of costs (exceeding more than 30 times the estimated cost) of complying with contract requirements.

Judge Peacock didn't buy it.

There was more to his decision, but we're not going to report it. You can read it yourself (link above). But one point that we should mention is that PHI argued it had been prejudiced by the award of a CPFF contract (vs. a FFP type). As you may recall, we've asserted before that using Cost-Type SBIR Phase 2 contracts is a difficulty that negatively impacts too many small businesses. So we were somewhat sympathetic to PHI's complaints. Here's how Judge Peacock dealt with them—

Appellant raises several contentions regarding the propriety of awarding PHI a cost-reimbursement contract with allegedly onerous accounting requirements. These contentions appear to be founded in appellant's belief that the CO abused her discretion in selecting the contract type by failing properly to consider the factors set forth in FAR 16.104. Appellant implies that the government should have reviewed and assessed the adequacy of appellant's accounting system prior to awarding the contract. PHI also states that it notified the government that appellant was 'ignorant of its responsibilities under a CPFF agreement.' … Therefore, appellant contends it never should have been awarded the CPFF contract in dispute.

While appellant may have avoided requisite formal audit review had a fixed-price contractual vehicle been selected, it would have assumed the risk of cost increases without the protections afforded by the LOC clause. In essence, in the reverse of the more typical situation where the contractor argues that such risks were not properly allocated to it by a fixed-price contracting vehicle, appellant here suggests that it was an abuse of discretion not to allocate appellant such risks. … Appellant was not prejudiced by selection of the CPFF contractual arrangement. The most obvious point is that appellant would not have received more than the fixed-price of the contract. Equally significant and, as emphasized throughout this opinion, the simple protection and solution for appellant was to provide the overrun notice and await notice from the CO that the estimated costs of the contract were increased before expenditure of the funds in question. Appellant was repeatedly advised of its rights and obligations under the LOC clause and could not have been confused. PHI was aware of these issues almost from the very inception of the contract yet knowingly entered into it. … No abuse of discretion occurred ….

So here's the deal. PHI was a clueless contractor that never, ever, should have accepted its contract. It didn't understand what it was signing and it didn't understand the administrative requirements associated with a cost-type contract. We've written about this phenomenon before.

PHI is very lucky that it is not facing a criminal investigation into its accounting and billing practices. In fact, everybody from the auditor to contracting officer to government attorney to Judge seems to have gone out of their way to handle this small business with kid gloves.

Learn from the mistakes of PHI. Don't make similar mistakes yourself. The treatment afforded PHI is unusual; a company that pursued a similar path would be in deep trouble, more likely than not.

Do not do this.