ARMED SERVICES BOARD OF CONTRACT APPEALS

Appeal of -	)	
	)	
Pratt & Whitney, a division of Raytheon Technologies Company	)	ASBCA No. 59222
	)	
	)	
Under Contract No. N00019-10-C-0005	)	

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OPINION BY ADMINISTRATIVE JUDGE SCOTT

Pratt & Whitney (Pratt or P&W) has appealed under the Contract Disputes Act (CDA), 41 U.S.C. §§ 7101-7109, from a Defense Contract Management Agency (DCMA) Divisional Administrative Contracting Officer's (DACO's) final decision (COFD) dated December 24, 2013, asserting a $210,968,414 claim against it. The COFD alleges that Pratt did not comply with Cost Accounting Standard (CAS) 418, Allocation of Direct and Indirect Costs, from January 1, 2005 to December 31, 2012, due to its use of manufacturing target costs (MTC) in lieu of revenue share payments as the cost of jet engine parts provided to Pratt under collaboration agreements.[1] As we elaborate upon

[1] There is no dispute that the contracts at issue are CAS-covered. The CAS is codified

below, Pratt acquires certain commercial engine parts from "collaborators." Unlike ordinary part suppliers, the collaborators share in the revenues and expenses of the engine programs. Each part is assigned an MTC for internal purposes. The sum of a supplier's MTCs, as a percentage of the total engine cost, represents the supplier's Gross Revenue Share (GRS) or percentage of participation in the engine program. However, Pratt does not pay the GRS to the collaborators, but reduces the amount actually paid by Pratt to the collaborator by the collaborator's share of certain expenses, resulting in a Net Revenue Share (NRS). The COFD also asserts a claim under Federal Acquisition Regulation (FAR) 31.201-5, CREDITS.[2]

Pratt alleges that it complied with CAS 418; disputes the credit claim; and contends that DCMA breached a settlement agreement resolving these issues. In June 2019, the Board conducted an 11-day hearing in Hartford, Connecticut on entitlement only. The appeal is subject to a protective order. For the reasons set forth below, we sustain the appeal in part and deny it in part.

FINDINGS OF FACT

Pratt's Commercial and Military Engines Businesses

1. During the period relevant to this appeal, Pratt was one of the principal business segments of United Technologies Corp. (UTC).[3] Pratt's financial results are consolidated into UTC's financial statements. (R4, tab 714 at 2; tr. 5/122) Pratt designs, develops, manufactures, sells, and services jet engines for military and commercial aircraft. Manufacturing Operations (MO) is Pratt's business segment "that produces the engines, modules and spare parts for commercial and military customers" (tr. 9/40) and provides product support (R4, tab 498 at 4756). Commercial Engines (CE) is the business segment that sells commercial engines to commercial customers. Military Engines (ME) is the business segment that sells engines to the U.S. and foreign governments. Pratt uses the same manufacturing operations and facilities for military and commercial engines. (Tr. 1/52, 9/40-41) "[The] material comes into the same wells and is handled the same, regardless if it's commercial or military . . ." (tr. 3/66).

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at 48 C.F.R. §§ 9903-05.

[2] We quote pertinent CAS and FAR provisions following our findings of fact.

[3] A segment is one of two or more business units or divisions that report directly to a home office. *See* CAS 403-30(4), Definitions. On April 3, 2020, UTC consummated a merger with Raytheon Company. Raytheon Company became a wholly owned subsidiary of UTC, which changed its name to Raytheon Technologies Corporation. This decision refers to Pratt and UTC as they were organized during the period at issue.

2. In the commercial market, Pratt sells an engine to an airframer (*e.g.*, Airbus or Boeing), which installs the engine on an aircraft. [redacted] The airframer then sells the aircraft with Pratt's engine installed to the ultimate customer, typically an airline. Upon delivery of the aircraft to the airline, Pratt pays the airline a "Fleet Introductory Assistance" (FIA) concession, an amount aimed at incentivizing the airline to select Pratt's engine. (Tr. 5/108-10, 6/204) FIA can take many forms, including, *e.g.*, cash, [redacted] to airlines in the competitive market, to gain an advantage over Pratt's competitors-primarily General Electric and Rolls Royce (tr. 5/110, 230-31, 260-61, 6/204-05, 7/143, 152-55, 243; *see, e.g.*, app. supp. R4, tab 1183 at 144881 ¶ 3.1, which names FIA amounts and examples of FIA[4]).

3. Pratt has been a party to collaboration agreements since the late 1970s (*e.g.*, R4, tab 463). William McIntire, Pratt's financial director of administration and negotiations for risk and revenue share collaborations (tr. 6/80-81), identified the following commercial engine programs in which Pratt was engaged during the 2005-2012 period pertinent to this appeal: the JT8D, GP7000, PW2000, PW4000, PW6000, and V2500, sometimes referred to as "legacy engine programs" (tr. 6/82-83, *see also* tr. 8/27-28). Pratt was also involved in the Geared Turbo Fan (GTF) engine programs. The record is unclear as to whether they were in development or production by December 31, 2012. (Tr. 1/104, 6/81-82) The government did not deem the GTF programs to be relevant to its noncompliance determinations (*see* tr. 1/103-04).

4. For the legacy engine programs, the vast majority of FIA Pratt provided to its airline customers was in the form of cash. Regardless of the form of FIA, it is recorded at the same time that Pratt books the sale of the engine and is netted against the gross revenue. (Tr. 4/231-32, 5/146-48, 6/11; undisputed app. proposed finding of fact (UAPFF) 109-110)

Collaboration Agreements

5. Pratt gets engine parts by manufacturing them, purchasing them from vendors, and obtaining them from collaborators under collaboration agreements. The costs are included in Pratt's direct material allocation base. (Tr. 6/96, 9/40–41, 43) Collaboration agreements are long-term risk and revenue-sharing arrangements that Pratt has entered into with financially capable engine component manufacturers for the design, development, production, sale, and product support of commercial jet engines and spare

[4] The government objects to this document on the ground that it is based upon a joint venture, Pratt and Whitney and General Electric Engine Alliance, LLC, agreement with [redacted] (airline) and that appellant allegedly did not disclose any other FIA arrangements to it (*see* tr. 5/264, 269). We overrule the objection but cite the document for the limited purpose of its recitation of FIA examples.

parts (tr. 7/137-39, 8/25). For economic reasons, Pratt's collaborators are normally foreign entities (tr. 6/237-38). Under the agreements, Pratt and the collaborators share in virtually all aspects of an engine program, including program risks, expenses, obligations, and revenues, for the decades-long life of the program (tr. 1/149-50, 5/41, 6/98-99, 7/137-39, 230-31, 8/20, 25).

6. Under the collaboration agreements, collaborators share in engine program expenses and revenues based upon their "program share," the percentage of an engine program for which a collaborator is contractually responsible. For example, a collaborator with a 12.5% program share is responsible for 12.5% of program expenses, and shares in 12.5% of the engine program revenues, principally from sales of engines and spare parts. (*See, e.g.*, app. supp. R4, tab 87 at 17161; tr. 8/28-30)

7. Pratt tracks part production by its collaborators and determines annually their contributions against their obligations and whether each collaborator has over or under-produced parts that year. The parties engage in annual "over/under" true-ups or settlements in the case of over- or under- production compared to revenue share. (R4, tab 149; *see* app. supp. R4, tab 87 at 17156 ¶ 3.6.1, Short Term Imbalance; R4, tab 335; tr. 6/129, 212-18, 7/190-92, 8/43-44, 9/170-71, 175-76). "[W]hether or not a partner who is getting his . . . program share NRS [net revenue share], is meeting that partner's obligation to provide program share hardware" is not measured in actual cost but at MTC value (tr. 6/129).

8. Motoren-und Turbinen-Union Muenchen GmbH (MTU), a German jet engine manufacturer, is one of Pratt's primary collaborators. MTU participated as a risk-revenue sharing partner [redacted] It specializes in the design and manufacture of two jet engine modules: low-pressure turbines and high-pressure compressors. (*See* app. supp. R4, tab 87; tr. 5/40, 8/12-15, 27-28; ex. A-385 (report of Pratt's expert, Ms. Cheryl A. LeeVan, at 5, Chart 2)) [redacted] (tr. 8/9-10, 12, 15-16). He explained that collaborators must have sufficient capital to make the major investment required and accept the risks of effectively owning "a bigger chunk of an engine" (tr. 8/21). This gives them a strategic advantage over smaller parts manufacturers (tr. 8/21-22, 35).

9. Pratt enters into collaboration agreements to share in and mitigate the major investment requirements and risks of the commercial jet engine market (*see* below and tr. 7/146-47, 149-50, 8/22-25; ex. A-385 at 39-42). Pratt exchanges a share of the engine program's future revenues for a collaborator's program share of expenses (tr. 7/166). The collaboration agreements determine a collaborator's revenue share and the expenses for which the collaborator is responsible. Pratt works out with its collaborators a cash management policy concerning how and when they will receive cash. (Tr. 5/40-42, 76, 129)

10. Mr. McIntire explained, through a demonstrative exhibit, that, in contemplating collaboration agreements, Pratt considers [redacted] It refers to its maximum [redacted] as the "bucket." Its objective is to get collaborators to improve the bucket by reducing the amount of [redacted]. In exchange for having collaborators provide the cash flow and take program risks, they share in the after-market revenue side of the business, known as the "tail," which is what makes a program profitable. Pratt is willing to exchange its share of the tail for the collaborator's share of the bucket. (AD12, [Pratt] Partnership Strategy Affordability and Risk Mitigation; tr. 7/165-66)

11. Under its collaboration agreements, Pratt generally assigns a "production basket of parts" to a collaborator (tr. 6/96-97). To the extent that there is a requirement for those parts, the collaborator is expected to deliver them. For that delivery, the collaborator earns "production input credit at the MTC price" (tr. 6/97).

12. In collaboration arrangements GRS generally refers to the list price of engines or spare parts multiplied by the collaborator's program share or revenue share. NRS is GRS less FIA, Drag (addressed below) and other program expenses. MTU receives NRS, for example. Pratt does not use the terms "NRS" and "GRS" for accounting purposes and they are not recognized in its financial statements. (Tr. 5/43-44, 6/230)

13. In addition to paying a share of the FIA expenses, the collaborators' program shares are also reduced by their percentage share of "Drag" (tr. 7/144). Additionally, collaborators are obligated to pay their program share of [redacted] (tr. 7/146).

14. To the extent that the collaboration agreements require collaborators to pay Pratt program "entry fees" at any time, or to pay Pratt for any form of "pre-certification expenses," the agreements provide that such fees and expenses are "nonrefundable" (*see, e.g.*, R4, tab 468 at 13518 ¶ 5.1; tr. 6/184-85, 187-88, 193, 8/72). A collaborator must reimburse Pratt for the collaborator's share of program expenses that Pratt incurred even before the collaborator joined the program (tr. 6/184).

15. Although Mr. McIntire's testimony was not entirely clear, he stated, in sum, that Pratt pays collaborators for "very little" other than parts (tr. 6/110, 114). On the other hand, he also testified that "there's a lot of consideration beyond just parts that [a collaborator] is getting paid for" (tr. 6/173). However, the examples Mr. McIntire gave were expense reimbursements and the like that the collaborator owed to Pratt

(tr. 6/173-75). When Mr. McIntire returned to the stand the next day, he elaborated upon his view of what Pratt paid collaborators for other than parts and gave the following examples of costs the collaborators share in: (1) entry fees, which are the up-front payments by collaborators when they join a program; (2) sharing in FIA and concessions to airlines (3) pre-certification engineering costs of continuing to develop an engine to get it certified as safe to fly; (4) costs of getting an engine into the market; (5) after an engine enters into service, collaborators also share in post-certification engineering (PCE) costs, a continued investment required to get an engine installed on an airplane and to maintain and manage it throughout its operating life; and (6) sharing in the aforementioned Drag, guarantee and warranty expenses. A collaborator's contribution may take the form of cash or services. (Tr. 7/139-48) Mr. McIntire acknowledged on cross examination that the alleged contributions by collaborators are items for which they pay Pratt, not payments by Pratt to them (tr. 7/248-49).[5]

16. [redacted]

17. [redacted] described MTC as "a theoretical value, a notional cost lever" (tr. 8/40). The "major thing" was that it should be "round out cost" and "it is a notional value." "[I]t's never, say, the true cost . . . ." (*Id.*)

18. Consistently, in *Rumsfeld v. United Technologies Corp., Pratt & Whitney*, 315 F.3d 1361 (Fed. Cir. 2003) (*Rumsfeld*), the predecessor litigation at issue (addressed below), Pratt averred that:

> MTC is not the actual cost of a part to anyone but, rather, is the "target cost" established at the outset of the program before any parts are designed.

(R4, tab 679 at 17 ¶ 37 (app's post-hearing br., statement of facts))

[5] To the extent that the GRS or NRS paid by Pratt to the collaborators could include a return on the investments made by the collaborators, Pratt has not quantified the asserted return. *See* finding 179.

19. A "round out cost" includes all manufacturing overheads of the company but not any other company overheads. [redacted] cost estimators work on estimating MTC for purposes of its collaboration agreement, then it negotiates with Pratt concerning MTC. The MTC estimates do not include sales general and administrative expenses (SG&A) (tr. 1/57) and profit. (Tr. 8/40-41, 55) Of "major importance" is that the MTC value cannot be changed over the years (tr. 8/42).

20. Mr. McIntire also declared that MTC is not an actual cost. Rather, it is a notional, estimated, cost. It is an estimate by Pratt of what the learned-out manufacturing cost would be at a point in time in program production using best manufacturing methods to try to ascertain what is achievable as a target cost. No one ever told him that it was an actual cost. (Tr. 6/118, 122, 125, 130)

21. MTC is Pratt's measuring basis for contributing its program share of its production products. Outside the basic collaboration sphere, Pratt uses MTC for [redacted]. (Tr. 6/148-50)

22. As a general rule, Pratt finds that, at the first stages of an engine program, [redacted] Pratt has also compared the actual cost of buying a part from a vendor to the MTC value Pratt assigns to it. Again, Pratt has found that, [redacted] (Tr. 6/150)

23. The expectation is that a commercial engine program will last 50 years, which increases economic risk because the market can change completely over that time period (tr. 7/138, 150, 8/24). Engine program risk results from the substantial time and investment required to design, develop, and certify commercial jet engines. A new engine program requires an enormous investment in engineering and design work, which can exceed [redacted] before an engine is certified for airworthiness and may be sold. A program might not be profitable and might suffer from negative cash flow for several years. As an engine program matures, it requires spare parts, and revenues and operating margins for component suppliers tend to increase. (*See, e.g.,* R4, tab 457 (Avio 2005 Report for Note Holders) at 26; tr. 7/149-50, 155-58, 9/180–81, 11/42) Pratt begins to make money, i.e. profits, in the aftermarket sale of spare parts (tr. 6/100-01).

24. Collaborators receive their share of program revenues throughout the life of a program. Engine sales and revenues related to aftermarket sales of spare parts are the main sources of revenues. A collaborator receives its full percentage program share in the revenue from an engine sale even if its parts are not on the engine, and it receives its

full percentage program share in the revenue from spare parts sales even if it has not provided any of those parts. (Tr. 7/148-49) In terms of gross amounts, comparing engine sales to spare parts sales, the latter are "by far" the largest revenue source (tr. 2/262; *see also* tr. 2/296 (spare parts are the largest revenue source)).

25. In Mr. McIntire's experience, collaborators are willing to enter an arrangement where they are likely to lose money for several years because "the aftermarket revenues are very, very lucrative" (tr. 7/156). He characterized the collaborators' role as having to "pay to play" (tr. 6/186-87, 7/234).

26. In all of its collaborations, Pratt serves as the lead collaborator, maintains the largest program share, and is responsible for the overall management of the engine program (app. supp. R4, tab 1488 at 52-53, n.15; tr. 5/119-20, 123).

27. Occasionally, during the life cycle of the legacy engine programs, collaborators have [redacted] (Tr. 7/192-93, 203, 222-23; UAPFF 86; gov't reply br. at 15, response to APFF 87)

Predecessor Litigation[6]

28. This litigation is the *Jarndyce v. Jarndyce* of the cost accounting world.[7] It never ends. While the litigation started in the early 1990's, the question of Pratt's cost accounting practices regarding collaborators dates back to 1984 (tr. 4/26). On January 24, 1992, DCMA's then-DACO, James F. Swift, issued a Final Finding of Noncompliance that Pratt's cost accounting practices for its commercial collaboration agreements did not comply with CAS 410, Allocation of Business Unit General and Administrative [G&A] Expenses to Final Cost Objectives; CAS 418; and CAS 420, Accounting for Independent Research and Development [IR&D] Costs and Bid and Proposal [B&P] Costs. The basis for the DACO's finding was that Pratt had allegedly failed to include "'an appropriate measure of the cost of parts consigned by collaborating partners in the expense allocation bases.'" *United Technologies Corp., Pratt & Whitney*, ASBCA No. 47416 *et al.*, 01-2 BCA ¶ 31,592 at 156,118, *rev'd Rumsfeld v. United Technologies Corp.*, 315 F.3d 1361 (Fed. Cir. 2003) (quoting Final Finding of Noncompliance With CAS 410, 418 and 420) (Board's 2001 decision). (*See also* R4, tab 129 at 109) The DACO determined that the "'revenue shares of sales . . . would be

[6] We mention portions of the predecessor litigation in our findings of fact, for context, but address the legal implications in our Discussion (below).

[7] *See* Charles Dickens, *Bleak House* (1852-53).

the fairest measure' of the value of the 'consigned parts'" and found that the noncompliance period was retroactive to 1984. *United Technologies Corp., Pratt & Whitney*, 01-2 BCA ¶ 31,592 at 156,118. There is no indication in the record before us that DACO Swift's Final Finding of Noncompliance mentioned MTC or Drag. Pratt sought a COFD. When DCMA did not respond, Pratt appealed to the Board from a deemed denial, which the Board docketed as ASBCA No. 47416.

29. On December 2, 1996, then-DACO William Morrow issued a COFD finding, as reported in the Board's 2001 decision, that Pratt had:

> [I]mproperly excluded collaboration material from its allocation bases. He concluded that the collaborators were "in essence subcontractors or vendors" to Pratt and that the *net revenue share payment represented a cost to Pratt which should be . . . included in its allocation bases* for the calculation of its MOH, G&A and IR&D/B&P rates. He determined that Pratt's failure to do so did not comply with the "requirement for a causal or beneficial relationship between indirect expenses attributable to collaboration parts and the final cost objectives that include collaboration parts" and violated CAS 410, 418 and 420.

United Technologies Corp., Pratt & Whitney, 01-2 BCA ¶ 31,592 at 156,119 (*see* app. supp. R4, tab 85 at 3-4) (Emphasis added)

The COFD determined that *"*[*t*]*he net revenue share payment represents a cost to P&W because it is what P&W actually pays to its collaborators for the parts it receives*" (app. supp. R4, tab 85 at 3) (emphasis added). The decision defined "net revenue share" as "[g]ross revenue share less amounts deducted for DRAG credits" (*id*. at n.1). The DACO found that the noncompliance resulted in a cost impact of $260,290,111 during the period 1984 through 1995 and demanded payment (*id*. at 4). While it mentioned Drag, the Morrow COFD did not mention MTC. The Board docketed Pratt's appeal from this COFD as ASBCA No. 50453.

30. In 2001, the Board sustained ASBCA Nos. 47416 and 50453.[8] As part of its analysis, the Board reviewed the testimony of six individuals who were accepted by the Board as experts in, *inter alia*, the CAS; cost accounting for government contract purposes; generally accepted accounting principles (GAAP); and organizational economics and industrial organizations. They testified on the nature of the revenue share payments made to collaborators and the business relationships under which those

[8] The Board denied a consolidated appeal, ASBCA No. 50888.

payments were made. *United Technologies Corp., Pratt & Whitney*, 01-2 BCA ¶ 31,592 at 156,122-27.

31. The Board concluded that the economic substance of collaborator relationships should govern over their form, and that the collaborators were not subcontractors:

> We have concluded that the collaborators are not subcontractors to Pratt and that the program revenue share payments distributed by Pratt to them should not be treated as payment for the cost of the parts they manufacture. Accordingly, Pratt is not required to include revenue share payments distributed to its collaborators in its MOH allocation base . . . . Pratt's accounting for collaboration parts complies with [the relevant] CAS requirements.

United Technologies Corp., Pratt & Whitney, 01-2 BCA ¶ 31,592 at 156,132.

32. On appeal, in 2003, in *Rumsfeld*, the U.S. Court of Appeals for the Federal Circuit discounted the expert testimony at the Board and analyzed the terms "cost" and "material cost" by reference to standard dictionaries, the FAR and the Uniform Commercial Code. 315 F.3d at 1369-71. It found that those terms, as used in the CAS, "include the revenue share payments made by Pratt for the parts under the collaboration agreements." *Id*. at 1372. The court did not specify whether it was referring to "gross" revenue share or "net" revenue share payments, after deductions for amounts a collaborator owed to Pratt. However, footnote 13 provided that the "input cost" required that the "cost of a part thus must be measured as of the time it is used in production." *Id.* The court held that Pratt purchased parts from its foreign parts suppliers, and that the revenue share payments "comprise" costs for those parts. *Id*. at 1377. (We address the term "comprise," a disputed issue, in our Discussion below.) The court vacated and remanded the case. In footnote 19, the court stated:

> To the extent that Pratt may argue that some portion of the revenue shares represented payments for items other than parts, Pratt may provide that evidence on remand. The burden is upon Pratt, however, to show that the revenue share payments included payments beyond that for the collaboration parts. The question of the propriety of

> removing Drag from the indirect cost pool is also not before us on appeal, and remains open on remand.

Id. at 1377 n.19.[9]

33. Pratt's use of "MTC" and "Drag" are at issue in the current litigation. In *Rumsfeld* the Federal Circuit adopted the Board's definition of the terms:

> Pratt was the only entity that had a direct contractual relationship to the purchasers of the engines. The foreign parts suppliers had no direct relationship to the purchasers. However, under the collaboration agreements between Pratt and each parts supplier there was a complicated agreement that involved substantial risk sharing. Pratt did not pay a preset price for the collaboration parts. Instead, under the agreements, each collaborator was assigned a percentage share of the engine program ("program share"). Substantially all of the collaboration agreements required each collaborator to pay to Pratt a substantial up-front "program entry fee" directly related to its program share. The collaborator was to receive its program share of the revenues derived from the engine sale by Pratt "in consideration of the parts manufactured." The collaborator was to supply parts with an "equivalent engine value" based on its [MTC], *i.e.,* parts with a particular combined value in relation to the total value of the engines produced by Pratt (the relative value of the parts being equal to the program share). The MTC of a part was "the estimated cost of each part if Pratt were to manufacture the part." The collaborators also shared in certain costs that Pratt incurred for the engine programs, because a fee called "Drag" was subtracted from their revenue shares, the Drag representing Pratt's "disproportionate program expenses," which include "overhead for the program management and administration, marketing and sales, product support, material handling, and other administrative functions." The amount of "Drag" was based on a negotiated agreement between Pratt

[9] After the Federal Circuit remanded the appeals to the Board, the parties settled them (below). Thereafter, DCMA asserted the claims currently at issue. Although this appeal is arguably not part of the remand, Pratt asserts, and DCMA has not challenged, that there is no dispute that this appeal is governed by *Rumsfeld* (app. br. at 77). We agree that, where relevant, *Rumsfeld* controls. We address it further in our Discussion below.

> and each collaborator. The express language of the collaboration agreements also provided that the relationship between Pratt and the foreign collaborators was that of independent contractors and not as partners.
>
> The collaboration parts were used by Pratt either directly to construct engines or as spare parts.

Rumsfeld, 315 F.3d at 1364-65 (citations omitted)

34. The evidence in the current litigation concerning Drag is consistent with that in the prior litigation. In recognition of Pratt's lead role and the many expenses it incurs to manage the program, under the collaboration agreements Pratt withholds Drag, a negotiated percentage reduction from the collaborator's revenue share, from its payments to a collaborator. Drag expenses include Pratt's "disproportionate" share of engine program expenses that are not incurred by the other collaborators, such as material handling; shipping; "customer-facing" activities by the sales force; marketing and product support; employee wages and fringe benefits; and related administrative expenses. (Undisputed portion of APFF 40; R4, tab 329 at 9; tr.5/80-81, 6/198-00, 7/143-44, 8/37; ex. A-385 at 81, ¶ 146)

35. Amy Johnson, Pratt's vice president and controller (tr. 5/34-35), referred to Drag as a negotiated "fee" from a collaborator that Pratt earns as lead collaborator in a program (tr. 5/62, 80-81) or a "tax on revenue share" (tr. 5/87). She stated that Drag is effected through a reduction of the collaborator's share of gross revenue. Drag is recorded as a reduction in cost of sales. It can include many different kinds of things. (Tr. 5/80, 85-86)

36. Pratt's expert LeeVan described Drag in her expert report as revenue share payments being "reduced or 'dragged' down" (ex. A-385 at 81, ¶ 146). We address Drag, MTC and her report further, below.

Pratt's Financial Accounting for Collaboration Programs

37. In *Rumsfeld* the court noted that, in 1996, Pratt changed its accounting practice regarding its payment to collaborators:

> From the inception of the collaboration agreements until July 2, 1996, after this dispute arose, Pratt treated its payment to collaborators differently for public financial statement purposes. For that purpose, Pratt treated the payments as a "cost of sales." Cost of sales represents the cost to the seller of the products sold. After this dispute arose in 1996, Pratt

> issued a public statement stating that the revenue shares would instead be treated as a reduction of gross sales, using Pratt's internal accounting methodology. This accounting change meant that for financial statement purposes the collaboration parts would no longer have an associated cost.

Rumsfeld, 315 F.3d at 1366.

38. Upon Pratt's sale of an engine or spare part, Pratt records the revenue and accounts receivable in its general ledger (undisputed gov't proposed finding of fact (UGPFF) 107). For Pratt's financial reporting, it classifies a collaborator's share of revenue as a cost of products sold, with Drag as a reduction to the cost of products sold. It does not break Drag out into specific accounting categories or offset it against specific expenses. (Tr. 5/61-62, 80-81, 85, 87, 191-92) However, each collaborator agreement defines the elements of Drag recovery for that particular collaborator (R4, tab 143 at 253061). From 2005 through 2012, the period at issue in this appeal, there were no material changes in the collaboration agreements' DRAG provisions (tr. 11/134; UGPFF 171).

39. As Pratt's vice president/controller Johnson described it:

> Drag isn't explicit around the amounts, so instead of trying to figure that out, we record drag consistently across our programs as a reduction of cost of sales because drag can include many different types of things.

(Tr. 5/85) Pratt determined that, given the range of Drag rates in its various programs, it would account for Drag as a reduction in cost of sales "versus allocating it across expense categories" (tr. 5/87). However, Pratt was able to allocate the elements of Drag to specific line item expenses and formerly did so (tr. 5/88).

40. According to an internal Pratt memorandum dated July 19, 2007, after its 2006 settlement with the government (below):

> With the elimination of the government requirement to allocate the recoveries by these line Items, the Government Accounting Group will no longer provide the allocations. In general, the allocation to the expense line items would not benefit P&W as a whole while requiring a great deal of manual work for analysts during closing.

(R4, tab 143 at 253062; UGPFF 166)

41. On December 12, 2007, the Financial Accounting Standards Board (FASB) issued EITF (Emerging Issues Task Force) 07-1, "Accounting for Collaborative Arrangements," which it incorporated into its Accounting Standards Codification (ASC), Section 808, "Collaborative Arrangements," effective for financial statements after December 15, 2008. Pratt adopted EITF-07-1 as of January 1, 2009. (R4, tab 712B at 52, tab 723; app. supp. R4 tab 1488 at 1, n.1, 53; *see* tr. 1/241, 4/192, 5/46-47; *see* GPFF 105)

42. EITF-07-1 states in part:

> For costs incurred and revenue generated from third parties, the participant in a collaborative arrangement that is deemed to be the principal participant …should record that transaction on a gross basis in its financial statements.

(EITF-07-1 ¶ 17; *see* ex. A-385 at 25)

43. A June 23, 2009 internal Pratt memorandum advised that Collaboration Accounting would "[c]alculate the revenue share payment, including determination of applicable offsets (e.g., FIA, warranty, and certification expenses" (R4, tab 175 at 19781)).

44. UTC's annual Form 10 K for the fiscal year ended December 31, 2009 (which covered Pratt (*see* R4, tab 712B at 3)) reported that:

> The Collaborative Arrangements Topic of the FASB ASC requires that participants in a collaborative arrangement report costs incurred and revenues generated from such transactions *on a gross basis* and in the appropriate line items in each company's financial statements.
>
> . . . .
>
> We adopted the provisions of the Collaborative Arrangements Topic as of January 1, 2009. As required, we have applied the provisions retrospectively for all periods presented. As a result, the collaborators' share of revenues, which were previously reported on a net basis, are now reported on a gross basis. Certain reclassifications were made to the prior year amounts in both the Consolidated Balance Sheet and Consolidated Statement of Operations. In the Consolidated Balance Sheet, accounts receivable and accounts payable were each increased by $368 million at December 31, 2008,

> in order to reflect the amounts owed to our collaborative partners for their share of revenues on a gross basis.

(R4, tab 712B at 52, n.15)

45. In its publically reported financial statements for all periods relevant to this appeal, Pratt reported collaboration program revenues net of FIA. Said to be relying upon GAAP, it treats FIA as a reduction in revenue rather than as a cost or expense. (Tr. 5/44-45, 56, 110-12, 115, 124-25, 131, 198; undisputed portion of APFF 104) Pratt accrues the full amount of FIA as a liability to the airline at the time Pratt delivers an engine to the airframer (tr. 5/146-48). FIA is the most significant reduction from revenue share payments. It is typically the single greatest reduction in the engine program revenue. (Ex. A-385 at 19, ¶ 36; UAPFF 110). In Ms. Johnson's experience, "[it] would be grossly overstating revenue" if Pratt did not exclude the FIA concessions from revenue (tr. 5/112). Pratt always reports revenues net of FIA. It reported revenues net of FIA both before and after EITF-07-01 (tr. 5/115, 125).

46. Under EITF 07-01, Pratt, as lead collaborator, was required to include the collaborators' share of revenue in cost of sales instead of netting it against Pratt's revenue. As a result of EITF 07-01, Pratt reports the collaborators' share of revenue, net of FIA, in Pratt's revenues, and reports collaborators' share of revenues, net of FIA, as an expense in cost of sales, or cost of products sold. It must also include a footnote disclosing the amount of collaborators' revenue share that is included in cost of sales. (App. supp. R4 1488 at 51, n.15; tr. 4/193, 5/118-20, 131-32, 238; ex. A-385 at 27-28)

47. Since 2009 UTC has included a footnote in its public financial statements that notes the requirement that Pratt include all collaboration program revenues (net of FIA) in its revenues and in its expenses (tr. 5/56-57, 123-24). The footnote states in part:

> Revenues generated from engine programs, spare parts sales, and aftermarket business under collaboration arrangements are recorded as earned in our financial statements. Amounts attributable to our collaborative partners for their share of revenues are recorded as an expense in our financial statements based upon the terms and nature of the arrangement.

(App. supp. R4, tab 1488 at 51)

48. For financial accounting purposes, Pratt does not record a cost in inventory when it receives engine parts from a collaborator. Pratt incurs the obligation to pay a collaborator when there is a sale of an engine or spare parts. If nothing is sold in a given month, Pratt does not owe a collaborator. (Tr. 2/11, 5/116, 150-53; APFF 117 and gov't

response.) Pratt takes "flash title" to the parts when the sale occurs. Under this flash transfer Pratt takes title "for a second." (Tr. 5/150-51) Pratt then has the obligation to pay its "partner"[10] its share of revenue, net of FIA (tr. 5/151). A collaborator can pay FIA to Pratt by check or it can be netted out from the wire transfer payment Pratt makes to the collaborator (tr. 5/152). Ms. Johnson expressed that "[w]e don't buy parts from the collaborators. They share in the revenue of the program" (tr. 5/116).

49. In its collaboration agreement administration, Pratt uses the terms "hard pegging" and "soft pegging." A part is "hard pegged" when it is consumed from inventory, which can take minutes to years. Hard pegging means that a part is assigned to a requirement and will not change. A sale does not occur until hard pegging and the inventory is cleared in the receiving well or in the shipping well. "Soft pegging" means aligning a part to a requirement based upon dates and first in/first out priorities. This can change depending upon actual use. (Tr. 8/96, 101)

50. In the late 1990's, Pratt changed from a practice of just subtracting Drag from wire payment transfers to a collaborator and billing it separately for FIA and PCE, to netting down the total wire transfer payment by subtracting DRAG, FIA, PCE and program expense obligations from it. Pratt's reasons for the change were to simplify procedures; consider the time value of money by eliminating the time waiting for an invoice to be paid; and eliminate the need to pursue a collaborator that did not pay (tr. 6/175-76). According to Mr. McIntire, the change "better matches the concept of a true net revenue share," which is the collaborator's share of revenues less Drag, FIA, concessions, PCE and anything else that renders the payment "more of a true net revenue position for a collaborator" (tr. 6/176-77).

51. Pratt's MO pool of expenses includes costs such as procurement, supplier quality, supply chain management, expenses, material handling, receiving, scheduling and other costs. It allocates its MO costs associated with the manufacture and sale of engines between its military and commercial businesses. Pratt's direct material allocation base includes three types of direct material: direct material associated with parts that Pratt manufactures; vendor parts that it buys from suppliers; and collaborator material valued at MTC. (Tr. 9/42-43; ex. A-385 at 30 ¶ 55)

52. Pratt enters the parts it purchases from vendors in its accounting system at their incurred cost, which is the purchase price that Pratt actually pays, net of any discount or concession. Pratt enters into the general ledger the direct material cost of parts it manufactures. It does not add G&A and profit to those costs. (Tr. 9/43-45)

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[10] As reflected above, witnesses, documents and counsel sometimes referred to collaborators as "partners," (*see, e.g.*, tr. 6/86, 88, 7/167, 8/27, 9/180), although Mr. McIntire denied any partnership in the legal sense (tr. 7/245).

53. Pratt does not recognize a cost at the time it receives a part from a collaborator (tr. 9/44, 10/150) (*see* finding 48 and below).

54. According to Ms. Lazinsk, Pratt defines MTC as "notional" on the alleged ground that "there is no cost incurred associated with a collaborator part when it's received into the production process" from GAAP and government cost accounting perspectives (tr. 9/46-47).

55. Prior to *Rumsfeld* Pratt did not include a cost in its allocation base for parts supplied by collaborators. After *Rumsfeld* held that collaborator parts did have a cost and it was "revenue share" (finding 32), Pratt changed its accounting practices in three ways. Since January 1, 2005 it has used MTC in its MO allocation base as the cost of collaborator parts. Pratt also [redacted] and it discontinued Drag credits in its overheads. (Tr. 9/45-46; *see* below) Previously Pratt had estimated its Drag credits allocation and had made various different Drag adjustments in several separate indirect cost pools (tr. 9/27-28).

56. According to Ms. Lazinsk, Pratt interpreted *Rumsfeld's* reference to "revenue share" to mean GRS less the deductions that collaborators share in as part of their collaboration agreements (tr. 9/64). She testified credibly that collaborators are "never paid [GRS]" (*id.*; *see also* tr. 9/95 (same)).

Post-*Rumsfeld* Events

57. On November 24, 2003, Administrative CO (ACO) Alan R. Tinti issued a COFD, again claiming that Pratt's accounting treatment of the collaboration agreements did not comply with CAS 410, 418 and 420, and asserting a claim against Pratt for $754,682,978, covering the period 1984 through 2002 (app. supp. R4, tab 129 at 3313-14).

He stated:

> I find that Pratt's continuing failure to date to include [its] payments to "collaborators" in its allocation bases continues to violate CAS 410, 418 and 420. I agree with and reiterate the Government's position, articulated throughout the litigation of this matter before the Armed Services Board of Contract Appeals and the resulting appeals, that the full amount of revenue share payments, sometimes called the "gross" revenue share payment, constitutes Pratt's cost for the parts the "collaborators" supply to it. Accordingly, I am adjusting the cost impact Mr. Morrow assessed in his December 2, 1996 decision to reflect the impact of Pratt's

> excluding the gross revenue share payments from its allocation bases between 1984 and 1995 and to reflect Pratt's continuing exclusion of its revenue share payments from the allocation bases through 2002.

(App. supp. R4, tab 129 at 3313) While the December 2, 1996 COFD had been based upon the cost impact using "net revenue share payments" (app. supp. R4, tab 85 at 3), the November 24, 2003 COFD concluded that Pratt's cost for collaborator parts was based upon GRS. This significantly increased the cost impact assessed in the earlier COFD. The decision did not mention MTC or Drag. The Board docketed Pratt's appeal from the November 24, 2003 COFD as ASBCA No. 54512.

58. The cost impact calculation used for the claim asserted in the November 24, 2003 COFD contained errors and was overstated, in part because the Defense Contract Audit Agency (DCAA) treated an F-117 (stealth fighter jet) collaboration part as commercial when it was military (tr. 3/145-46). The DACO at the time, Ms. Eileen Ennis, recalled that "at least $150 million" of the government's demand should have been in the military base and not the commercial base (tr. 7/32).

59. By letter dated May 25, 2004, Pratt notified DACO Ennis that it intended to change its cost accounting practices, effective January 1, 2005, to correct the CAS noncompliances cited in *Rumsfeld*. It submitted a cost impact proposal. (Ex. A-9 at 11976-77; *see also* ex. A-8 at 3394 *et seq*.) Pratt stated that it "has been studying alternative accounting practices that would correct the CAS non-compliance found by the CAFC, both going forward and for prior years" (ex. A-9 at 11976). Pratt proposed to change [redacted]
Regarding MTC, Pratt proposed to:

> [i]nclude [MTC], the estimated cost of collaborator-produced parts used in establishing collaborators' production shares, in [Pratt's] [MO] cost allocation base.

(Ex. A-9 at 11977) Pratt also proposed to discontinue its prior practice of crediting indirect cost pools for Drag (*see* ex. A-9 at 11984, n.9[11]; *see also* R4, tab 107 at 9842-43; tr. 7/45).

60. We have not been directed to any evidence that Pratt studied an accounting practice that would attribute "revenue share" to collaborator parts as of the time the parts were used in production. The testimony by Pratt personnel is to the contrary. For

[11] Pratt noted that it continued to assert that *Rumsfeld* was in error (ex. A-9 at 1977 at n.2).

example, Ms. Lazinsk testified as follows:

> Q To your knowledge, after *Rumsfeld* was decided, did Pratt ever conduct any kind of study or examination to determine whether or how it could record a revenue share based cost as the cost of collaboration parts in the overhead base?
>
> A Not that I'm aware of, no.
>
> Q Was that, was the matter of a possible cost accounting change that used a revenue share based cost as the cost of collaboration parts ever discussed in Pratt?
>
> A No. Our belief was that manufacturing target cost was the cost of the parts.

(Tr. 8/263; *see also* tr. 7/298-99) (similar testimony of Mr. Michael Munley, who held senior cost accounting positions at Pratt (tr. 7/254))

61. Ms. Lazinsk confirmed that, after receipt of DACO Ennis' disposition notice, Pratt's alleged CAS 418 noncompliance should be corrected (below), but Pratt never did anything to correct the noncompliance (tr. 8/292). She was not aware of any particular materiality threshold; believed that it was up to DCAA and the DACO; and believed that the DACO was the appropriate person to make materiality determinations under the CAS (tr. 9/24-25).

62. Ms. Lazinsk understood that CAS 418 requires in a direct material overhead base that actual cost be used for the direct material and that, under the CAS regulations and *Rumsfeld*, "material cost or cost of the parts is the price you pay" (tr. 8/263). She disagreed with DCMA counsel's proposition that "the cost of the parts that Pratt pays is revenue share" and responded that "[r]evenue share is not a cost of parts," but is a calculated number that identifies a collaborator's share of the revenue from an engine sale by Pratt (*id.*).

63. Pratt's cost impact proposal concerned the CAS noncompliances asserted in the COFDs at issue in ASBCA Nos. 47416, 50453, and 54512. On July 27, 2004, Pratt noticed an appeal from the deemed denial of the cost impact component of its submission and the Board docketed the appeal as ASBCA No. 54692. (*See* R4, tab 129 at 109-10)

64. By letter of September 7, 2004 to DACO Ennis, Pratt enclosed a revised CAS Disclosure Statement describing the planned changes to its accounting practices and a rough order of magnitude (ROM) cost impact analysis for Calendar Year (CY) 2005 (R4,

tab 105 at 11178). As related to Pratt's manufacturing overhead allocation base, the revision stated: "Material received from collaborators valued at [MTC]" (*id*. at 11191).

65. Prior to January 1, 2005, Pratt did not record anything in its material overhead base for collaborator parts. On January 1, 2005, Pratt implemented the changed accounting practices described in its May 25, 2004 letter (finding 59) and revised Disclosure Statements (*see* tr. 3/168). The forward pricing rate agreements and DCMA forward pricing rate recommendations for each year from 2005 to 2010 used MTC as the cost of collaboration parts in the material overhead base. The forward pricing rate recommendation in 2010 included MTC for the cost of collaboration parts. (Tr. 3/44-45, 8/248, 9/60-62)[12]

Audits

66. In a draft statement of conditions and recommendations (SOCAR), as described in Pratt's February 14, 2005 letter to DCAA (finding 77), DCAA rejected Pratt's MTC proposal on the grounds, among other things, that it did not comply with CAS 418 or *Rumsfeld* (*see* R4, tab 107 at 9841). DCAA also disagreed with Pratt's intention to remove Drag credits from its indirect cost pools, alleging that this would violate FAR 31.201-5 (*see id*. at 9842-43).

67. In connection with DCAA's audit of Pratt's revised disclosure statement, Marianne Hart, a supervisory auditor at DCAA during the relevant time periods and a DCMA cost price analyst as of the hearing (tr. 3/68-69), prepared a work paper, dated January 4, 2005, "to determine materiality of the cited CAS 418 noncompliance." The work paper's "conclusion" states:

> The proposed practice of including MTC in the MO MOH base would cause increased cost on government contracts of [redacted] when compared with the CAS compliant MO MOH base. Therefore, this noncompliance is considered material.

(R4, tab 506 at 5116; tr. 3/82-83)

68. To her recollection, Pratt never described MTC to Ms. Hart as an actual cost it pays for collaborator parts and, in her view, notional costs are not actual costs (tr. 3/80, 91).

69. Scott Moss, a certified public accountant (tr. 5/159), was Pratt's manager of collaboration accounting from 2009 until mid-2017. The Collaboration Accounting

[12] *See also* tr. 7/59-60 for pre-2010 period.

group was responsible for determining revenue share and applicable Drag and, among other things, making monthly payments to collaborators. The Collaboration Administration group was separate. Among other things, it kept track of the parts delivered by collaborators, which were recorded in Pratt's inventory system. It tracked MTC and reported on a monthly basis for collaboration accounting purposes. (Tr. 5/160-62, 170, 172, 9/41)

70. Mr. Moss described Drag as an agreed upon percentage, per a particular collaboration agreement, that would be reduced from the revenue paid to the collaborator. It appeared in the general ledger as basically an "other cost of sale." It was not on the collaborator cost of products sold line. (Tr. 5/170)

71. Mr. Moss did not use MTC in his job. Pratt did not make monthly payments of MTC to collaborators for parts. They were paid net revenue share. MTC values did not enter into the calculation of the amount of revenue share payable to collaborators. Mr. Moss does not believe that anyone at Pratt ever told him that MTC was the actual cost of the parts supplied by collaborators. (Tr. 5/171-73, 260)

72. In calculating the net revenue share to be paid to collaborators in cash, Mr. Moss and his Collaboration Accounting group never included an amount for return on investment or return on entry fee (tr. 5/237-38).

73. Ms. Susan Gest was Pratt's manager of Collaboration Administration from 2008 through 2012, prior to her retirement in 2013. Collaboration Administration was the conduit between Pratt and its collaborators. It communicated with them regarding financial information and supplied them with monthly reports produced by Collaboration Accounting. (Tr. 9/162-64) Collaboration Administration tracked parts by collaborator and knew to which engine program a part related (tr. 9/168).

74. A January 15, 2012 "Collaboration Administration-Financial Procedure" document on the subject of "Settlements-Over/Under Production Contribution," signed by Ms. Gest, described the process of establishing and communicating the values of the annual over/under production contribution settlements between Pratt and its collaborators (below) (R4, tab 335 at 39799, 39803; tr. 9/165) The document defined "MTC" as:

> [N]otional cost estimates that are assigned to program parts. The dollar amount of over or under production is expressed in MTC values. MTC values are normally used only when referring to the value of an individual part, or when

> calculating the dollar value of a collaborators' (sic) over or under production.

(R4, tab 335 at 39799) It defined "Equivalent Engines," or "EEs," as:

> The MTC value of a part(s) expressed as a percentage . . . of the total value of an engine. Production contribution is tracked by part number and its EE value instead of its MTC value. [redacted]

(*Id.*; *see also* tr. 9/166-67)

75. A February 10, 2012 Pratt "Collaboration Administration-Financial Procedure" document, on the subject of "Government Accounting-Collaborator Supplied Part Costs," defines "MTC" as "the notional cost value (manufacturing direct and indirect expenses, excluding SG&A and profit) of collaborator supplied parts" (R4, tab 287 at 41068).

76. Ms. Gest described MTC not as an "actual cost" but as "a negotiated cost with the collaborators because we didn't know their actual cost" (tr. 9/178). She stated that in Collaboration Administration there were cost engineers who were knowledgeable about how much it should cost to manufacture a part, [redacted] (tr. 9/179-80). Ms. Gest opined that Pratt did not pay for parts. The collaborators were not vendors but were part of an engine program like a partner, but that term was not used due to tax implications. Pratt was the lead on the programs. The collaborators provided parts to Pratt but some also provided post-certification engineering and were credited with that effort. Those who did not engage in the engineering reimbursed Pratt for the costs. (Tr. 9/180-81)

77. In a February 14, 2005 letter to Supervisory Auditor, Ms. Anne Farrelly, Pratt disagreed with DCAA's SOCAR. It asserted, *inter alia*, that "MTC is the best measure of the 'cost' of collaboration parts" (R4, tab 107 at 9842).

78. In an April 7, 2005 email to others at DCAA, Ms. Hart explained her position on Drag credits:

> [U]nless we can show that some of the overhead expenses related to the collaborator parts are allocated to the government contracts, the credits are not allocable. If the

> credits are not allocable, they are not allowable on government contracts.

(Ex. A-28 at 3) Her view was that, in order for the government to share in the credits, it must prove that the overhead expenses were allocated to government contracts (tr. 3/102-03).

79. Ms. Hart was interviewed on April 28, 2010, during a DoD Office of Inspector General (OIG) investigation of the parties' 2006 settlement of their disputes (below) (app. supp. R4, tab 861). Between that interview and a subsequent OIG interview on December 14, 2010, Ms. Hart recused herself from the Pratt CAS 418 noncompliance audit issues. Mr. Ed Higgins then became the supervisory auditor. Ms. Hart explained that, after her first interview, she had been second-guessing herself and getting confused. She wanted a "clean break, clean supervisor [and] clean opinion." (App. supp. R4, tab 915 at 57; tr. 4/101-02)

80. Although Ms. Hart expressed uncertainties and caveats, she concluded in her December 14, 2010 OIG interview that she had not changed her position on the Drag credit issue (App. supp. R4, tab 915 at 46-48). As of the 2019 hearing, Ms. Hart no longer believed that the government bore the burden of proof on the credits issue. She opined that it was incumbent upon Pratt to show that its credits practice complied with the FAR. (Tr. 3/183) Ms. Hart believed that, while the government concluded that Drag credits should stay in the overhead pool, it did not test to see if Drag applied to any costs that had been allocated to government contracts and reimbursed by the government (tr. 3/192).

81. Regarding revenue share payments, Ms. Hart found that collaborators are paid when they share in the revenue, not necessarily when parts are delivered. Pratt did not record a cost for collaboration parts in its books and records at the time parts were delivered. (App. supp. R4, tab 564, tr. 3/158-59, 4/90) It was her understanding that the "revenue share . . . exchange happens at the end of the process, after the part is incorporated into the engine" (tr. 3/279).

82. It is undisputed that:

> In a series of audit reports issued on September 23, 2005, DCAA challenged Pratt's January 1, 2005 cost accounting practice changes. *See, e.g.*, [Rule 4, tab 498]. DCAA alleged that Pratt's use of MTC as the cost of collaboration parts in its indirect cost allocation bases violated CAS 418 because Item 4.1.0(b)(1)(d) [in] the revised Disclosure Statement stated that material received from collaborators was "valued" at MTC

> and CAS 418-50(d)(iv) determines that a material "cost" base is appropriate. [R4, tab 498 at 4750]

(UAPFF No. 154; *see also*, R4, tab 498, ex. A-39 (listing reports))

83. For example, one of the September 23, 2005 audit reports, No. 2641-2005B19200001, stated that Pratt had proposed unilateral accounting changes in 2004, which it had implemented on January 1, 2005, which did not comply with CAS 418 and FAR 31.201-5. This included the use of MTC, which was not the cost of collaboration parts, as *Rumsfeld* had determined. Also, "[t]he proposed practice to stop applying Drag credits to the MO MOH pool and the MO [G&A] pool" violated FAR 31.201-5. (R4, tab 498 at 4748) The report elaborated:

> [T]he practice included in the revised language of the disclosure statement is in noncompliance with CAS 418 and [*Rumsfeld*] that the **cost** of the collaboration parts is revenue share. CAS 418-50(d)(iv) determines that a material **cost** base is appropriate for the allocation of indirect costs if the activity being managed or supervised is a material-related activity.

(*Id*. at 4750) The report continued:

> Since the court has determined the cost of the collaboration parts to be revenue share, the use of MTC, P&W's estimate to manufacture the parts, is in noncompliance with CAS 418.50(a)(2).
>
> We recognize that footnote 19 [in *Rumsfeld*] does permit P&W to argue that some portion of the revenue share "represents payments for items other than parts". However, until such information is presented and evaluated, we will continue to require that the cost of the collaboration parts included in the MOH base be total revenue share.

(*Id*. at 4751)[13] The audit report recommended that Pratt "remove any reference to [MTC] in the MO disclosure statement and replace it with 'Revenue Share'" (*id*.).

[13] DCAA disagreed with Pratt's position that the change to use of MTC was a change in accounting practice. Rather, according to DCAA, the proposed addition of collaboration parts to the manufacturing overhead base was a proposed correction of a noncompliance. Pratt was not changing the method by which costs in the base were measured; it was merely adding a cost to the existing base that should have

84. Contrary to appellant's contention (app. br. at 115), we have not located, and have not been directed to, any allegation in the September 23, 2005 2641-2005B19200001 audit report that Pratt's use of MTC had a material cost impact on the government or even a mention of materiality. (*See* R4, tab 498)

85. Another of the September 23, 2005 audit reports, No. 2641-2005B19200004, pertained to Drag (Drag audit report) (R4, tab 544). The report articulated DCAA's position that Pratt's accounting treatment of Drag violated the FAR 31.201-5, CREDITS, cost principle as follows:

> Prior to January 1, 2005, the contractor had accumulated [redacted] These credits were originally implemented by the contractor in 1992 as an attempt to resolve the initial finding of CAS noncompliance due to not including collaboration parts in various allocation bases. Since the contractor has proposed a [redacted] it has asserted that it is proper to now cease the practice of the credits. In addition the contractor has asserted that the credits are a reduction of the cost of the parts (revenue share) provided by the collaborators and not a reduction of P&W indirect cost allocated to government contracts.
>
> DCAA's opinion is that "Drag" credits should be accounted for in the same manner as the corresponding "Drag" costs were accounted for, i.e., in the indirect cost pools. Based on the definition in the [redacted] collaboration agreement with [redacted] "Drag" credits are payments for allowable costs that were accumulated in the contractor's indirect cost pools. Any credits or refunds related to those costs should be returned to the same cost pools to which they were charged.
>
> The fact that the "Drag" credits were received by P&W as a reduction in the revenue share P&W paid to the

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been included originally. (R4, tab 498 at 4751) Nonetheless, as reflected in our fact findings, the parties and other documents of record have referred to the matters at issue as accounting changes or practices.

> collaborators is not relevant. Subtracting the "Drag" credits from the revenue share payments owed by P&W was just the method the parties agreed upon to deliver the credits to P&W, not a decisive factor in how the credits should be accounted for. The credits were not for a reduction in the price of the collaboration parts; instead, they were payments for the disproportionate costs P&W incurred for the collaboration program that were charged to P&W's indirect cost pools. P&W's long-standing accounting treatment (i.e., crediting the indirect cost pools) of the "Drag" credits is manifestation and implementation of P&W's understanding of the nature of the "Drag" credits.
>
> Therefore, the proposed practice is in noncompliance with FAR 31.201-5 . . . .

(R4, tab 544 at 7175-76) DCAA recommended that Pratt continue to allocate Drag credits to its various segments. Otherwise, the discontinuance of its practice of crediting its overhead pools with Drag received from its collaborators would violate FAR 31.201-5. (*Id*. at 7176)

86. By letter of October 24, 2005 to DACO Ennis, Pratt disputed the September 23, 2005 audit reports (R4, tab 111). Regarding Drag, it acknowledged that it had been concerned in the past with apparent accounting inequities and had adjusted its accounting treatment of Drag accordingly. However, post-*Rumsfeld* it changed its accounting treatment of Drag again and asserted that the prior circumstances no longer applied:

> By July of 1991, Pratt had concluded that it did not incur a "cost" for collaboration material and, accordingly, that collaboration material should be excluded [redacted] Pratt also recognized, however, that Pratt was withholding revenue share payments to its collaboration partners in consequence of Pratt's having provided a disproportionate share of the support that collaboration parts received from indirect functions, principally MOH activities. Thus, Pratt was including no cost for collaboration parts in the allocation bases while allocating the full amount of all indirect cost functions to other non-collaboration parts, despite the fact that collaboration parts also benefited to some extent from the indirect cost functions. Concerned with the apparent inequity of this practice, Pratt concluded that it should credit its indirect cost pools for the amount of drag

> withholdings from revenue share distributions to the collaboration partners and that to do so constituted compliance with the credits cost principle. Accordingly, Pratt amended its Disclosure Statement to incorporate this methodology and, by letter dated December 23, 1992, tendered a voluntary refund to the Government reflecting the impact that crediting the pools would have had on negotiated firm fixed price military contracts for the years 1986 through 1991….
>
> . . . .
>
> Pratt has now changed its cost accounting practices to reflect the noncompliance upheld by the Federal Circuit in 2003. Under Pratt's revised practice, collaboration material is included in the MOH base and receives its allocable share of the costs of MOH activities, as does all other material included in the allocation bases. Accordingly, crediting the overhead pool for drag no longer serves any equitable or valid accounting purpose; to the contrary, including a cost for collaboration parts in the MOH base and also crediting the MOH pool for drag effectively results in a windfall for the Government. In short, Pratt's treatment of drag under its prior practice is completely irrelevant to determining the proper accounting for drag under its revised practice.

(*Id*. at 4)

DCAA Review, Settlement Agreement, Accounting Practices Agreement, and Dispositions[14]

87. During 2006 negotiations preceding the settlement of the litigation, DACO Ennis and Mr. Donald E. Nichols, Pratt's Controller, ME, met several times to discuss the appropriate settlement amount (UGPFF 70). During an April 29, 2006 meeting Pratt gave DCMA a copy of a proposed settlement agreement, signed by Mr. Nichols, which included settlement of the "2005 Forward issues" as part of the $283,000,000 settlement amount (app. supp. R4, tab 555 at 3; UAPFF 160).

88. On May 3, 2006, DACO Ennis, Ms. Hart (then a DCAA Senior Auditor), Ms. Lazinsk and another Pratt representative met to discuss revising Pratt's Disclosure

[14] In the context of this appeal, a "disposition" was the DACO's resolution of audit report findings regarding compliance or noncompliance with the CAS (tr. 1/51).

Statement (app. supp. R4, tab 564). That same day Ms. Lazinsk submitted "updated Manufacturing Disclosure Statement Sections 1.6.1 and 4.1.0 with wording clarification regarding Collaborator Material in the Material Overhead Base" to DACO Ennis (ex. A-76 at 25629). Ms. Lazinsk noted that the changes did not change the manner in which Pratt accounted for the cost (*id*.).

89. Pratt's "Collaboration Administration-Financial Procedure" document (Collaboration document), on the subject of "Government Accounting-Collaborator Supplied Part Costs," effective May 3, 2006, and incorporated into its Disclosure Statement, contained the following pertinent definitions:

> Engine Equivalency (EE)-The notional cost value of a program part, assembly or entire engine expressed as a percentage, or in decimal form, of the total notional cost value of the all parts [sic] in the original base year engine.
>
> . . . .
>
> Manufacturing Target Costs (MTC)-the notional cost value (manufacturing direct and indirect expenses, excluding SG&A and profit) of collaborator supplied parts on the [redacted] programs.
>
> Notional Part Value (NPV)-the notional cost value for Collaborator supplied parts on the [redacted] program.
>
> . . . .
>
> Part Base Value (PBV)-the notional cost value for Collaborator supplied parts on the [redacted] program.

(R4, tab 502 at 4887-88)

90. On May 3, 2006, DACO Ennis asked DCAA to audit the revised Disclosure Statement (*see* app. supp. R4, tab 586 at 2909). Ms. Hart's work papers report that:

> Eileen called the meeting to ask [Pratt] to provide a disclosure statement revision and supporting documentation to help resolve the current DCAA cited CAS 418 noncompliance with [MTC]. At the meeting I explained that section 1.6.1 of the disclosure statement does permit the[m] to use a less formal accounting technique to identify cost of parts. Since P&W does not record the cost of collaboration

> parts on the formal books of record, we would allow a less formal technique as long as they could support that the less formal technique reasonably reflects the Cost of the collaboration parts.

(App. supp. R4, tab 564)

91. On May 5, 2006, Pratt submitted an "updated version of the Settlement Agreement language" to DACO Ennis (app. supp. R4, tab 572), which included references to notices of disposition and settlement of the 2005 Forward issues (app. supp. R4, tab 574).

92. In response to the DACO's May 3, 2006 request, DCAA examined Pratt's revised material overhead disclosure statement and concluded in a May 5, 2006 draft audit report that the practice of using MTC to determine the cost of collaboration parts in the material overhead base was "compliant with CAS 418 and adequately described." However, DCAA opined that the practice did not comply with *Rumsfeld*'s conclusion that revenue share was the cost of the collaboration parts. DCAA did not consider the cost impact of the alleged noncompliance to be significant at the time. (App. supp. R4, tab 586 at 2909)

93. On May 10, 2006, Ms. Hart transmitted a revised draft audit report to her supervisor, Ms. Farrelly (ex. A-85). The draft stated in part:

> The contractor proposes to use [MTC] to determine the cost of collaboration parts included in MO's material overhead base. We find this practice compliant with CAS 418 and adequately described. However, it should be noted that the practice is not consistent with [*Rumsfeld*]. The court found that "revenue share payments" are the cost of the collaboration parts. . .
>
> . . . .
>
> Since P&W does not record the cost of collaboration parts as a cost on its formal books of record, P&W has proposed, via the Financial Procedure referenced in [sections 4.1.0 and 1.6.1 (C) of its revised Disclosure Statement], to use the established MTC as the practice to determine the cost of the parts.
>
> Although we recognize that [*Rumsfeld*] determined revenue share payments to be the cost of the collaboration

> parts, we reviewed the described procedure to determine if MTC is a valid measure of the cost of the collaboration parts. Based on the following conclusions, we have determined MTC to be a reasonable and stable measure of the cost of the collaboration parts[:]
>
> • A comparison of MTC amounts to purchase orders shows the MTC to be equal to or greater than purchase order amounts[.]
>
> • Consistent with subcontractor price, MTC includes material, labor, and overhead costs.
>
> • Once MTC amounts are established, the amounts cannot change without approval of the collaborator.
>
> • Certain collaboration partners have terminated their collaboration agreement and negotiated long term supply agreements with P&W where the foreign company is paid MTC as a purchase order amount.

(*Id*. at 1, 3; *see also* tr. 3/241) Ms. Hart agreed that the collaboration agreements included a specific dollar amount for MTC (tr. 3/245-46).

94. On May 11, 2006, Ms. Hart transmitted to Ms. Farrelly a revised draft audit report, which stated in part:

> Previously, . . . we reported this proposed practice in noncompliance with CAS 418 because the direct material base should include a cost that is consistent with [*Rumsfeld*]. That decision stipulated that "revenue share payments" comprise the cost of the parts. Subsequent to that report, the [DACO] has determined the revenue share payments to be defined as gross revenue share less Drag and FIA. Based on the DACO's determination of revenue share payments, we consider MTC to be an adequate measure of the cost of the collaboration parts. We now find this practice compliant with CAS 418 and adequately described.

(Ex. A-87 at 3)

95. By email of May 16, 2006 to Ms. JeanMarie Faris, Counsel, DCMA Hartford, Pratt's in-house counsel, Mr. David Ware, advised that he was drafting what he described

as "an Advance Agreement to address the 2005 forward issues" (R4, tab 119). On May 17, 2006 he sent her "a draft of an Advance Agreement" (R4, tab 121).

96. DCAA personnel exchanged a series of internal emails on May 16, 2006. In response to a comment from Ed Nelson, DCAA Northeast Regional Director (*see* APFF 173), that it is "obvious" that "there is a ton of profit in those engines," Ms. Hart opined: "What is obvious is that revenue share is a reimbursement to the partner for more than just part cost. I don't think we can make an assumption regarding profit without looking at all the other costs." (Ex. A-103)

97. However, Mr. Nelson directed the DCAA auditors to report that the use of MTC was noncompliant with CAS 418 and that, while the report would reference DCAA's comparison of revenue share payments (as defined by the DACO) to MTC, DCAA was not to opine on the significance or materiality of the comparison (app. supp. R4, tab 640).

98. Ultimately, in its audit report of May 24, 2006, DCAA determined that Pratt's revision to its disclosure statement adequately described its accounting practice but that its proposed procedure for determining the cost of the collaboration parts as MTC did not comply with CAS 418 and *Rumsfeld* (R4, tab 550 at 10029, 10031-32).

99. After Mr. Nichols' presentation of a draft settlement agreement to DACO Ennis, DCMA counsel, Ms. Faris and Pratt counsel, Mr. Ware, exchanged several additional drafts. The communications between them also included some discussion of the handling of the 2005 forward accounting issues. (Tr. 4/24, 35, 75, 10/245; UGPFF 78) Mr. Nichols stated that the Pratt and DCMA legal personnel "work[ed] out the actual agreements that ultimately got signed" in June 2006 (tr. 10/245).

100. On May 25, 2006, Ms. Faris sent to Mr. Ware "a markup of the settlement agreement based on the assumption that we will be signing a **separate agreement** on the 2005 forward issues" (R4, tab 127 at 967) (emphasis added). Mr. Ware referred to a separate agreement when he responded to Ms. Faris' removal of an accord and satisfaction clause as follows:

> If your concern is about Pratt trying to claw back the $283M, part of the whole idea of moving the 2005 forward issues to a **separate agreement** was so that we would not be able to claim the money back if the government failed to live up to a commitment made concerning the 2005 forward issues.

(R4, tab 127 at 966) (Emphasis added) Mr. Ware referred to the APA as an "Advance Agreement" (*id*. at 965-66; *see also* R4, tab 123 (Mr. Ware's May 18, 2006 email to Ms. Faris referring to separate Advance Agreement)). At the hearing, Ms. Faris noted

that Mr. Ware had offered the separate advance agreement. She understood the APA to have been executed pursuant to FAR 31.109, Advance Agreements. (Tr. 4/28-29, 36)

101. Although appellant listed Mr. Ware as a hearing witness, it ultimately did not call him to testify.

102. The parties eventually reached consensus to resolve the issues arising under the 1992 noncompliance determination, the 1996 and 2003 COFDs, and the appeals arising therefrom. This was memorialized in two agreements they signed and four documents issued by the DACO. The agreements and all of the other documents (below) were dated and/or effective on June 5, 2006 and signed that day during the same meeting. (R4, tabs 128-129; app. supp. R4, tabs 29-32; tr. 7/113-16, 10/247) Mr. Peter Leahy, DCMA Business Operations, Group Chief, advised government personnel by email dated June 5, 2006, on the subject of "Collaboration Agreement Signed," that Pratt and the DACO had signed "the agreement settling the collaboration issue" that morning and that he and the DACO "did the right thing and in the best interests of the Government" (app. supp. R4, tab 702).

103. The "Settlement Agreement," signed by DACO Ennis and Mr. Nichols, reported that the government's claims of CAS-noncompliance (collectively, the "Government claim") had been extended through December 31, 2004, and that the government was entitled to interest accruing to the June 5, 2006 effective date of the agreement. It stated that, with respect to various final negotiated indirect cost rates and forward pricing rate agreements, the government and Pratt had entered into savings agreements that, among other things, preserved the parties' rights to reopen the agreements depending upon the outcome of the then-pending appeals. The Settlement Agreement referred to these agreements as the "Savings Agreement Collaboration Provisions." (R4, tab 129 at 109-10)

104. The preamble to the Settlement Agreement provided in part:

> WHEREAS, effective January 1, 2005 and forward, Pratt changed its U.S. Government contract cost accounting practices for commercial Collaboration Agreements; and
>
> WHEREAS, the undersigned DACO is authorized under relevant law and regulations and any applicable delegations of authority to resolve on behalf of the Government all disputes, claims, issues, and disagreements relating to the Final Decisions, the Government Claim, the Appeals, and the Savings Agreement Collaboration Provisions; and

> WHEREAS, the Parties have determined that it is in their best interests to settle all matters in dispute under the Final Decisions, the Government Claim, the Appeals, and the Savings Agreement Collaboration Provisions:

(R4, tab 129 at 110)

105. The Settlement Agreement continued that:

> 2. In full and final Settlement of the Final Decisions, Government Claim, the Savings Agreement Collaboration Issues, and the Appeals, Pratt agrees to pay the Government $283,000,000 ("Settlement Amount"), said amount consisting of [redacted] through the Effective Date….
>
> . . . .
>
> 3. The parties agree that UTC's payments under the schedule stated in paragraph 2 fully and finally resolve the Final Decisions and the Government Claim, and that, accordingly, neither party will exercise its rights under the Savings Agreement Collaboration Provisions;
>
> 4. Upon receipt of the full Settlement Amount in accordance with paragraph 2 of this Agreement, the Government to the extent permitted by law hereby fully and forever, permanently and unconditionally, releases, extinguishes and discharges the Company and its past, present and future parents, subsidiaries, affiliates, predecessors, successors and assigns, and their directors, officers, employees, shareholders, agents, representatives, attorneys, heirs, executors, administrators, predecessors, successors and assigns, of and from any and all claims, disputes, demands, interest and damages of whatever kind, asserted or unasserted, known or unknown arising out of or relating in any way to the issues addressed in the Final Decisions, the Government Claim, the Appeals, the Savings Agreement Collaboration Provisions, including not only claims actually asserted but those that could have been asserted in the Final Decisions, Government Claim and the Appeals with respect to Pratt's U.S. Government contract cost accounting treatment of Collaboration Agreements.

> 5. Simultaneously with the Government's release of Pratt, Pratt similarly fully and forever, permanently and unconditionally releases, extinguishes and discharges the Government, its officers, agents and employees of and from any and all civil liabilities, obligations, claims, appeals, demands, interest and damages of any kind, whether known or unknown, asserted or unasserted, administrative or judicial, legal or equitable arising under or related in any way to the Appeals (ASBCA Nos. 47416, 50453, 54512 and 54692 . . .), including not only claims actually asserted by Pratt but also those that could have been asserted by Pratt in said Appeals with respect to Pratt's U.S. Government contract cost accounting treatment of Collaboration Agreements.
>
> 6. The parties hereto expressly recognize that this Settlement Agreement is entered into in accord and satisfaction of contested matters, as described above, and that the agreements described above do not represent an admission of liability or responsibility on the part of the Company or the Government.
>
> 7. This Settlement Agreement shall extend to and be binding upon the parties hereto and their respective agents, successors, and assigns.
>
> 8. Any disagreement or dispute that relates to this Settlement Agreement shall be a dispute under the [CDA].
>
> . . . .
>
> 10. This Agreement is the entire agreement between the Parties, and supercedes any prior agreements, whether oral or written, relating to the subject matter hereof. This Agreement may not be altered, amended, modified, or otherwise changed except by a writing duly executed by both Parties.

(R4, tab 129 at 110-12) (footnote omitted)

106. DACO Ennis and Mr. Nichols also signed the "Agreement Between the United States Government And United Technologies Corporation, Pratt & Whitney Division Regarding Certain Collaboration Agreement Accounting Practices" (APA),

which stated that it was "under authority of [FAR] 31.109 [ADVANCE AGREEMENTS], FAR 30.601 [RESPONSIBILITY], and FAR 33.210 [CONTRACTING OFFICER'S AUTHORITY]" (R4, tab 128 at 114).

107. The APA's preamble provided in part:

> WHEREAS, the Government, in a series of eight audit reports in 2005 and one audit report in 2006 . . . addressed issues regarding Pratt's accounting for commercial collaboration agreements (i.e. agreements with foreign firms relating to development and manufacture of jet engines and spare parts for commercial engine programs . . . effective January 1, 2005 forward (hereinafter the "2005 Forward issues"); and
>
> WHEREAS, the 2005 Forward issues include (1) Pratt's [redacted] (2) Pratt's discontinuance of its prior practice of crediting overhead pools with "DRAG", and (3) Pratt's use of [MTC] as the cost of collaboration parts; and
>
> WHEREAS, simultaneously with the execution of this Agreement, the DACO is executing the Disposition Notices (hereinafter the "Disposition Notices") and the Letter of Adequacy and Compliance (hereinafter the "Letter") . . . resolving the 2005 Forward issues in the manner described below; and
>
> WHEREAS, the undersigned DACO is authorized under relevant law and regulations and any applicable delegations of authority to resolve on behalf of the Government all disputes, claims, issues and disagreements relating to the 2005 Forward issues; and
>
> WHEREAS, the parties have determined that it is in their best interests to resolve the 2005 Forward issues through the date of this agreement and to agree upon the prospective use of the practices at issue;
>
> NOW, THEREFORE, in consideration of the promises herein, the parties agree as follows:

(R4, tab 128 at 114-15)

108. The APA continued with the parties' agreement:

> 1. The Disposition Notices and Letter conclude that Pratt's [redacted] was adequately described and compliant with CAS from January 1, 2005 to the date of this agreement. The Government approves Pratt's [redacted]
>
> 2. The Disposition Notices and Letter also conclude that Pratt's discontinuance of its prior practice of crediting DRAG to its overhead pools was compliant with both CAS and the [FAR] from January 1, 2005 to the date of this agreement. The Government will not require such credits prospectively, provided that Pratt continues to include a cost for collaboration parts in its allocation base or bases and that the "DRAG" provisions of the collaboration agreements do not materially change.
>
> 3. The Disposition Notices, the Letter, and this Agreement resolve the 2005 Forward [redacted] and DRAG credit issues. The Government shall take no further action on the audit reports addressing these issues, and the DACO hereby withdraws any and all interim or final findings of noncompliance arising under or related to these issues.
>
> 4. The DACO, in a Disposition Notice and the Letter, has advised Pratt that its use of MTC as the cost of collaboration parts does not comply with CAS but that the use of MTC does not presently result in a material amount of increased costs to the Government. Therefore, this noncompliance requires no contract adjustments at this time. However, the Government reserves the right to make appropriate adjustments should this noncompliance become material in the future. If the cost impact of using MTC becomes material when compared to using revenue share payments as the cost of collaboration parts, or if Pratt otherwise decides to discontinue using MTC as the cost of collaboration parts, the parties further agree to make a good faith effort to identify an appropriate portion of revenue share payments as the CAS-compliant cost of collaboration parts, or to identify another CAS-compliant means of addressing collaboration parts.

> 5. The Government waives its right to any cost impacts or interim or final rate changes relating to the 2005 Forward issues through the date of this Agreement, whether arising under or related to savings provisions in Pratt's CAS-covered contracts or otherwise.
>
> 6. The adequacy and compliance of any future cost accounting changes related to collaboration agreement accounting either made by Pratt or ordered by the DACO shall be governed by the [CAS] in effect at that time.
>
> 7. Nothing in this Agreement shall be construed as limiting (a) the Government's right and obligation to periodically review Pratt's accounting practices for adequacy and CAS compliance and to make determinations regarding such adequacy and compliance based on the facts and circumstances present at the time of such reviews and the laws and regulations then in effect; or (b) any audit right granted by law, regulation or any contract provisions.
>
> 8. This Agreement is in accord and satisfaction of the 2005 Forward issues to the extent stated in paragraphs 1 through 5 above. It shall extend to and be binding upon the parties hereto and their respective agents, successors and assigns to the extent permitted by law and regulation.

(R4, tab 128 at 115-16)

109. We have not been directed to any evidence that the APA was incorporated into any of Pratt's government contracts. It was not incorporated into the captioned contract, which the COFD at issue cited as a representative contract (R4, tab 334 at 187, tab 398). Moreover, the APA does not specify its duration.

110. Both before and after the APA was signed, Pratt used MTC in its forward pricing rate proposals, with the government's approval (tr. 9/157-59).

111. While DACO Ennis acknowledged that the parties were "all working to put everything together, to bed," (tr. 7/116), she insisted at the hearing that the Settlement Agreement and the APA were separate agreements (*see* tr. 7/57-59, 68, 86, 92, 111, 130).

112. One of the three disposition notices issued by DACO Ennis, concerning audit-alleged noncompliances, was entitled "Resolution/Disposition of DCAA Audit

Findings Regarding MO G&A Pool Composition and Elimination of DRAG Credits to Overhead Pools" and referred to one particular audit report (app. supp. R4, tab 29 at 495). It was signed as approved by DACO Ennis and Mr. Leahy (*id*. at 498).

113. DCAA had alleged that Pratt was in violation of CAS 410 and FAR 31.205, CREDITS. The disposition notice stated in part:

> Now that the CAFC has required the cost of collaboration parts to be placed in the allocation bases, P&W has acknowledged that it must put at least some measure of costs in the bases, and has therefore reversed its position on crediting overhead pools with DRAG.
>
> . . . .
>
> [T]he DACO concurs with P&W's argument that crediting the overhead pool for "DRAG" no longer serves any equitable or valid accounting purpose because including a proper cost for collaboration parts in the MOH base will now cause those parts to draw their commensurate share of overhead. Thus, continuing to credit the MOH pool for DRAG in this new circumstance would effectively result in a windfall for the Government. In short, P&W's treatment of DRAG under its prior practice (when no part cost appeared in the base) is irrelevant to determining the proper accounting for DRAG under its revised practice. This prior practice is also irrelevant to establishing the "part cost".

(App. supp. R4, tab 29 at 496-97)

114. The DACO also determined in the disposition notice that Drag was intended to cover overhead expenses that exceeded, i.e. were disproportionate to, a party's share of a collaboration program and not to any relationship between the overhead expenses of collaboration programs and other engine programs (app. supp. R4, tab 29 at 497). She relied in part upon the following definition of Drag from a March 8, 1991 collaboration agreement between Pratt [redacted]

> "DRAG" means the compensation, [redacted] required of one Party to compensate the other Party for the amount of overhead expenses incurred by such other ***Party in excess of the …other Party's Program Share of such expenses,*** including, without limitation, expenses relating to material handling,

> program management and administration, marketing and product support, but not including guarantee, warranty and service policy or product liability expenses. [Emphasis added by DACO]

(*Id*.) The DACO summarized that she agreed with Pratt that Drag was properly treated as a credit to material cost rather than to the various indirect cost pools (*id*.).

115. Another of the disposition notices, signed by DACO Ennis and Mr. Leahy, was entitled "Resolution/Disposition of DCAA Audit Findings Regarding LCE [Large Commercial Engines (gov't br. at 4)] and ME Pool Composition and Elimination of DRAG Credits to Overhead Pools" (app. supp. R4, tab 30 at 499). It covered three audit reports with, among other things, similar DCAA allegations as above and came to the same conclusion in favor of Pratt's treatment of Drag, "[b]ased on [the DACO's] legal review" (*id*. at 501).

116. A third disposition notice, signed by DACO Ennis and Mr. Leahy, was entitled "Resolution/Disposition of DCAA Audit Findings Regarding Inclusion of MTC as Cost of Collaboration Parts in MOH Allocation Base" (app. supp. R4, tab 31 at PW-503, 506). It covered three audit reports involving MTC. The DACO reported that Pratt had submitted a proposed procedure whereby the cost of collaboration parts would be determined based upon actual part receipt quantities and MTC. DCAA had concluded that the procedure for determining the cost of collaboration parts as MTC did not comply with CAS 418 and *Rumsfeld*. Pratt countered that MTC was an appropriate measure of the cost of collaboration parts for the purpose of allocating MO costs. As reported by the DACO, Pratt contended:

> Since MTC represents the negotiated "price" for parts based on, as a starting point, P&W's costs to purchase or manufacture, P&W believes MTC is an appropriate amount for CAS 418.40 purposes for three reasons. First, MTC is a negotiated amount between P&W and the respective collaborator predicated on P&W's purchase or manufacturing costs and is more closely akin to a "purchase order price" than revenue share payments, and is more predictable (i.e. not relying on the after-the-fact netting of costs from gross revenue share). Second, MTC amounts are readily trackable to quantities of parts, at the part number level, received from a collaborator. Third, and as DCAA current audit report confirms, the use of MTC or net revenue share amounts in the material overhead base produces by and large substantially the same result, a result not materially harmful to the Government.

. . . .

> Clearly, the best way to determine the appropriate portion or component of revenue share amount to include in the allocation base is to look to MTC, because MTC is actually used to measure a collaborator's contribution to the program and has the distinguishing virtue or advantage of [redacted] Pratt believes the Court's decision should be read to be consistent with CAS, not at odds with CAS, and therefore an input cost like MTC is to be preferred over that output cost value itself[.]

(App. supp. R4, tab 31 at 503-04)

117. The DACO set forth Pratt's explanation of MTC as follows:

> [P&W's] proposed practice for defining the cost of ["]collaborative parts" utilizes actual part receipt and [MTC]. P&W has explained the following:
>
> a) MTC is based on [redacted] of what these parts would cost if manufactured or bought. The MTC amounts include material, labor and overhead costs.
>
> b) MTC amounts are established in collaboration agreements [redacted] Those MTC amounts cannot be changed without the agreement of all partners participating in the engine program.
>
> c) A fully developed system currently exists at P&W to report MTC amounts monthly to both collaboration partners and Government accounting.
>
> d) MTC amounts are the basis for determining the price a partner will be paid for any parts produced in excess of the program share.
>
> e) [redacted]

agreements with P&W in which MTC is the purchased order price.

f) P&W provided purchase orders which reflected costs equal to or less than MTC amounts.

(App. supp. R4, tab 31 at 505)

118. The DACO decided in the disposition notice that, although noncompliant in her view, Pratt's inclusion of MTC as the cost of collaborator parts had practical advantages; was more consistent and more beneficial to the government in verifying incurred costs and forward pricing rates; and that, overall, the impact to the government from the use of MTC was immaterial. She disposed of the noncompliance on the latter ground without requiring contract adjustments. If the noncompliance were not corrected, the DACO reserved the right for the government to make adjustments should the noncompliance become material in the future. (App. supp. R4, tab 31 at 506)

119. In her "Letter of Adequacy and Compliance," as the APA referred to it, the DACO determined that Pratt's voluntary change to [redacted] and eliminating Drag credits to overhead pools at certain segments complied with the CAS and the FAR, whereas using MTC as the cost of collaboration parts did not comply with the CAS or *Rumsfeld*. However, she found that the noncompliance did not presently result in a material amount of increased costs to the government. It should be corrected but, if not, the government reserved the right to make appropriate contract adjustments if the noncompliance became material. (App. supp. R4, tab 32)

120. Ms. Ennis was the cognizant Federal agency official at Pratt at the time of the *Rumsfeld* remand. As the DACO for Pratt, she had a CO's warrant. (Tr. 3/148, 7/21, 8/147-48) Ms. Ennis was responsible for determining whether Pratt's disclosed practices were adequate and compliant with the CAS, and for resolving the cost impact of a noncompliance (tr. 7/22, 8/168-69). Ms. Ennis responded affirmatively to appellant's counsel's questions whether "the resolution and disposition of DCAA audit finding[s] was something that [she], as the warranted DACO, [was] required to do;" whether doing so was "within the scope of [her] authority as the DACO;" and whether at the time she signed the documents she believed they contained "[v]alid obligations of the United States with [Ms. Ennis] as its authorized representative" (tr. 7/116). The government has not come forward with any evidence that DACO Ennis was not authorized to execute the documents in question.

121. Mr. Leahy, the DCMA official one level above DACO Ennis, agreed that when DCAA issues an audit report with a CAS noncompliance, the contracting officer is required by regulation to disposition the audit findings (tr. 8/207-08). Mr. Leahy signed the disposition memoranda because approval at one level above the contracting officer

was required. He also agreed with Ms. Ennis' determinations. (Tr. 8/209-10) If Mr. Leahy had thought that Ms. Ennis's decision was contrary to the FAR or the CAS, he would not have signed the disposition memoranda (tr. 8/210-11). He opined that DACO Ennis had the authority to sign the Settlement Agreement and the APA and to resolve the disposition issues (tr. 8/207-08). No question has been raised about Mr. Nichols' authority to sign on behalf of Pratt.

122. Mr. Leahy opined that the Settlement Agreement was "looking backwards" and intended to resolve the pending litigation while the APA was intended to resolve the alleged CAS noncompliances "going forward" (tr. 8/155-56). He considered the Settlement Agreement and the APA to be two separate agreements (tr. 8/158, 204).

123. Ms. Faris was a government trial attorney in the initial ASBCA appeals and advised DACO Michael Olbrych in connection with the final decision in this appeal (below) (tr. 4/9-10, 51-52). She acknowledged, based upon her communications with Pratt counsel Ware, that it was Pratt's position that it wanted to resolve the litigation, which looked backwards, and the accounting issues, which looked forward (tr. 4/59-60). However, Ms. Faris explained that the government was unwilling to include the litigation issues and the accounting issues in the same agreement:

> [T]he government would not agree in the litigation settlement agreement to discussion of any forward-looking accounting practices, so those accounting changes that Pratt made in 2005 on January 1st. The government did not want to fully and finally settle those going forward in the same document as the settlement agreement because we couldn't agree, in perpetuity, to certain accounting practices. They were always going to be subject to audit, especially in the case of [MTC], which, the DACO had concluded was noncompliant with CAS, but at the time, immaterial, so we couldn't agree in perpetuity to those things.

(Tr. 4/29-30; *see also* tr. 4/37)

124. While the government objected to addressing the accounting practices in the settlement agreement, Ms. Faris acknowledged that "[o]bviously, if the Government wanted to have some type of agreement, going forward, in terms of accounting procedures, we couldn't leave them up in the air. But we didn't want them to be part of the settlement agreement of the litigation" (tr. 4/57).

125. Pratt's signing official, Mr. Nichols, stated that Pratt would not have signed the Settlement Agreement without the APA (tr. 10/247). He considered all of the documents to be part of one settlement:

> I believe everything was signed on June 5th, 2006 between Eileen Ennis and I, and I believe Peter Leahy was there as well. But all of these documents—again, they were all important, part and parcel, to the whole agreement, the settlement. And so they were all signed on exactly the same day.

(Tr. 10/247) Mr. Nichols acknowledged that the APA does not refer to the Settlement Agreement and it does not refer to the APA. He stated that "[t]here's two separate documents as it turned out" (tr. 10/262).

OIG Investigation

126. In January 2009, the Government Accountability Office's Fraudnet office forwarded to the OIG a September 2008 email chain from a "retired DCAA employee" criticizing the 2006 settlement (app. supp. R4, tab 792). The individual alleged that there was pressure from DCAA's and DCMA's highest levels to settle the litigation for an amount that was agreeable to the contractor rather than an amount that was fair to the taxpayer and that the amount was approximately $500 million lower than it should have been to be consistent with government procurement regulations, including the CAS (*id.* at 16902; *see also* app. supp. R4, tab 1358 at 8389).

127. After an extensive investigation, as stated in its May 30, 2014 report, the OIG found no evidence to substantiate the allegation of pressure from higher-level management to settle the litigation (app. supp. R4, tab 1358 at 8383, 8392). However, among other criticisms, the OIG concluded that DCMA had not complied with government regulations and the settlement amount was not substantiated:

> DCMA's settlement position was derived without obtaining sufficient documentation from Pratt to substantiate the [DACO's] prenegotiation settlement position consistent with FAR Part 31 "Contract Cost Principles and Procedures," the rules and regulations established by the Cost Accounting Standards Board, and the intent of the Court as stated in Footnote 19 [of *Rumsfeld*]. Because DCMA did not substantiate [its] position, we are not able to provide a reliable estimate of what the settlement amount would have been had DCMA complied with the regulations.

(*Id*. at 8395)[15]

[15] In connection with discovery disputes involving the OIG investigation, the Board

Post-Settlement Audits

128. On July 27, 2010, during the course of the OIG's investigation, DCAA issued an audit report on Pratt's March 2, 2010 proposal for forward pricing rates from CYs 2010 through 2012 (R4, tab 576 at 21074-75) (2010 forward pricing audit report). One of the stated purposes of the audit was to determine whether MTC "continues to be a reasonable surrogate for the cost of the collaboration material as defined using Revenue Share Payments (also known as NRS)" (*id*. at 21078). In part, the report addressed DCAA's continuing view that Pratt's practice of using MTC as the cost of collaborator parts was noncompliant with CAS 418. The report noted that Pratt had not provided NRS amounts in its proposal and that the auditors had requested MTC and NRS amounts as part of the audit (*id.* at 21094-95). Certain of the requested data were not provided until June 28, 2010 (*id*. at 21095). The report concluded that the noncompliance was "significant enough to materially impact the results of audit of the material overhead rate" (*id*. at 21080). The report recommended that "contract price negotiations not be concluded for the material overhead rate until the impact of using [MTC] rather than Revenue Share Payments in the proposed direct material allocation base [was] determined and considered by the contracting officer" (*id*.).

129. Mr. Brian Nardi was the lead auditor for the 2010 forward pricing audit. He drafted the audit report and reviewed the material overhead rate. (Tr. 2/68-69) Ms. Hart was the supervisory auditor (tr. 2/158). Mr. Nardi acknowledged that, in the audit report, "revenue share payments" meant NRS (tr. 2/165-66), but at the hearing, he disavowed some of the report's statements concerning NRS and said they were mistaken (tr. 2/161-69). As one example, he stated:

> Again, net revenue share, like I said, there was a confusion and really what we're meant to say was gross revenue share in most cases. But again, it'd have to be taken as a context throughout the report to see, you know, where there's an error and where not.

(Tr. 2/91) Mr. Nardi confirmed that GRS was DCAA's "final position on what is the correct way to value the collaboration material, not [NRS]" (tr. 2/113).

130. The government avers that DCAA's definition of NRS at the time meant GRS less only Drag (gov't reply br. at 25). However, the Nardi testimony it cites refers both to Drag and to a more expansive list of deductions provided by Pratt, such as FIA,

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conducted an *in camera* review of what appellant enumerates as 2,600 documents (tr. 6/68) and of the transcripts of OIG interviews of more than a dozen government employees.

test and certification expenses, entry fees, and expenses that Pratt invoiced to the collaborators (tr. 2/91-92, 95). Mr. Nardi agreed with appellant's counsel's description that Mr. Nardi's "understanding of net revenue share is gross revenue less items such as drag [and] invoices, which includes things like [fleet] introductory assistance, entry fees, and various other costs" (tr. 2/186).

131. The 2010 forward pricing audit report states variously:

> •[O]ur opinion on the material overhead rate is qualified to the extent that the material overhead base may be understated by using MTC rather than a NRS amount . . . .

(R4, tab 576 at 21078)

> •[T]he DACO did reserve the right to make adjustments should this impact become material in the future when comparing the MTC to [NRS] amounts.

(R4, tab 576 at 21094)

> •[T]he impact of the use of MTC rather than the use of NRS in the proposed direct material allocation base needed to be considered during our review of this FPRP.

(*Id*.)

> •Revenue Share Payments (also known as [NRS])

(R4, tab 576 at 21095)

> •[A]ctual payments (wire transfers) made to Collaborators

(R4, tab 576 at 21098)

(*See also* tr. 2/163-73)

132. On September 22, 2011, DCAA issued a CAS 418 noncompliance audit report, referred to by the parties and hereafter as the "192 audit" report. A "192 audit" is one that reports upon a noncompliance found in another audit (tr. 3/212; *see also* tr. 2/71). The 192 audit covered the period January 1, 2005, through the date of the audit. Mr. Nardi drafted the report but had a different supervisory auditor, who suggested that he revise his draft to refer to the cost of collaboration parts as "revenue share" rather than NRS. Mr. Nardi agreed. As issued, in contrast to the 2010 forward pricing audit report,

the 192 audit report compared MTC to GRS. (R4, tab 594 at 4461, 4464, 4473, tab 598 at 4539, 4541; tr. 2/211-12)

133. Mr. Nardi explained that DCAA's noncompliance report was not based upon the FASB directive EITF 07-1. The noncompliance had already been established in a previous 2005 audit report and, in his view, was supported by *Rumsfeld* and by Pratt's disclosure statement and policies and procedures that describe its valuation of collaboration material as an estimate. (Tr. 2/222)

134. In finding that Pratt's practice of using MTC as the cost of collaborator parts was noncompliant with CAS 418-50(a)(2), DCAA stated:

> The contractor's disclosed and established practices related to the material overhead (MOH) rate are considered noncompliant with CAS 418-50(a)(2). [Pratt's] disclosed and established practice is to use a direct material cost base to allocate material overhead. The direct material cost base includes parts received from collaboration partners at [MTC] and Total Engine Equivalency to Partners **(**TEEP), notional cost values. The use of MTC and TEEP in a material cost base is noncompliant with CAS 418-50(a)(2) since these amounts *are not P&W's actual direct material cost for collaboration parts.*

(R4, tab 594 at 4461) (Emphasis added)

135. Pratt's Collaboration document, effective May 27, 2008, like the May 3, 2006 document (finding 89), defined MTC as "the notional cost value (manufacturing direct and indirect expenses, excluding SG&A and profit) of collaborator supplied parts" (R4, tab 607 at 4671; tr. 2/77-80). Pratt's Collaboration document, on the subject of "Program Production Contribution," effective February 15, 2010, defined MTC as "notional cost estimates that are assigned to collaboration program parts" (R4, tab 186 at 6281). To DCAA auditor Nardi, "notional" meant "estimate" (tr. 2/79).[16]

136. In its 192 audit report DCAA stated that it did not consider notional cost values to be direct costs as defined by CAS for purposes of CAS 418 (R4, tab 594 at 4463). DCAA also found that Pratt's use of MTC instead of actual costs had a material impact upon the MOH expenses allocated to government contracts:

[16] "TEEP" and "PEV" (part equivalent value) are alternative terms used in at least two legacy programs, respectively, rather than MTC (tr. 1/245-46, 6/182-83; *see* complaint ¶ 15, n.2). According to DCAA, "TEEP" is "the notional cost value for collaborator supplied parts on the V2500 program" (tr. 1/57).

> Beginning January 1, 2009, P&W began recording a cost for collaboration parts in cost of sales (COS) accounts[17]. While performing our review of the P&W, MO Forward Pricing Rate Proposal (FPRP) for [CYs] 2010 through 2012 . . . we determined that the cost impact of using MTC in place of the CY 2009 actual cost recorded in COS accounts has a material impact on material overhead expense allocated to government contracts.

(R4, tab 594 at 4462) DCAA reported that the CY 2009 partner revenue share recorded in COS was [redacted] greater than the CY 2009 MTC, which affected Pratt's material overhead rate, resulting in an approximate impact upon government contracts of [redacted] (*id* at 4464).

137. Mr. Joseph Hart, the CACO as of the hearing, who also served as a DACO during relevant periods (tr. 1/7, 43-44), described the effect of the potential noncompliance noted in the 192 report as follows. The Manufacturing Operations Material Overhead Base is allocated to both commercial and military contracts. The value of the base is important because it will shift costs between those contracts. If one side's base is undervalued, it will shift costs to the other. In the government's opinion, MTC is not an actual cost and is "significantly lower" than GRS. Pratt's use of MTC lowered the amount in the commercial engines' share of the base, meaning the commercial business would have less overhead allocated to it and the government business would have more. (Tr. 1/58-59, 105)

138. Based upon the 192 audit report, then-DACO Brian Hawkins issued a September 28, 2011 notice of potential noncompliance with CAS 418 (R4, tab 5). On April 4, 2012, DACO Olbrych requested that Pratt "provide any evidence it has to establish that gross revenue share payments included payments beyond that for collaboration parts" (R4, tab 16). Pratt provided extensive amounts of information and engaged outside experts, Ms. Margaret Worthington and Mr. Gary Gutzler, who reported upon the question of whether revenue share payments included payment for items other than parts (tr. 9/95-98). With an August 10, 2012 letter to Mr. Olbrych, Mr. Michael Nisbet, then Pratt's Controller, ME, provided him with a copy of Ms. Worthington's expert report and Mr. Gutzler's analysis (R4, tabs 265 A-C). Neither individual was called as a witness in the subject

[17] The audit report stated that this change was required by Financial Accounting Standards Board EITF 07-1 – Accounting for Collaborative Arrangement (app. supp. R4, tab 967 at 121). *See also* "Pratt & Whitney, Commercial Engines, Accounting & Controls," dated December 15, 2010 (R4, tab 208 at 162203-04; tr. 1/133-34, 241).

appeal. Mr. Hart acknowledged that Pratt engaged in good faith discussions on the disputed issues (tr. 1/219-20).

139. Ms. Worthington opined that: (1) DCAA erred in concluding that CAS 418 required Pratt to value collaborator-produced parts in the material overhead allocation base on the basis of GRS; (2) as the government determined in 2006, Pratt's inclusion of MTC, in lieu of NRS, in the material overhead allocation base, did not result in a material impact upon material overhead allocated to Pratt's government contracts; and (3) if NRS were used in valuing collaborator parts included in the MOH allocation base, the NRS calculation must be adjusted downward to reflect PCE costs and collaborator return on entry fees (R4, tab 265 B at 1005-06).

140. The government read Ms. Worthington's report to opine that the use of MTC was "a better deal for the government and that the adjusted [NRS] was much lower than MTC" (tr. 2/235). However, DACO Olbrych found that the Worthington report showed that there was a "very substantial difference" between the use of MTC and GRS on government contracts that generated "a lot of impact to the government" (tr. 1/288).

141. Based upon DCAA's initial reading of the Worthington report, it misunderstood the meanings of GRS and NRS. As the government's understanding of collaboration arrangements evolved, it deemed it apparent that all of the expenses listed in the Worthington report, including Drag, were part of the overall part costs. (Tr. 2/291-92)

142. The government considered that all of its questions had not been answered. On August 29, 2012, DACO Olbrych sent a follow-up letter to Ms. Lazinsk. The remaining questions concerned Drag. The government still wanted supporting information concerning the propriety of Pratt's removing Drag from its indirect cost pool. The government's position was that, if Pratt incurred the Drag expenses for its collaborators, then those overhead expenses existed in its overhead pools. If the collaborators were reimbursing Pratt for those expenses, they should be removed from the overhead pools charged to the government. Otherwise, Pratt would be paid twice for the same overhead. Based upon the APA, from 2005-2012, Pratt did not credit Drag to the overhead pools. It had done so prior thereto. (R4, tab 271; tr. 1/116-19)

143. On May 7, 2013 DACO Olbrych issued to Pratt a Determination of CAS 418 Noncompliance (R4, tab 306; tr. 1/64-65).[18] He had determined that MTC was not an actual cost; it was a notional cost and there were "really large deltas" between the two that were "causing considerable financial harm to the government" (tr. 1/250-51). He stated that he disagreed with the former DACO's determination that Pratt's

[18] Mr. Hart participated in the drafting of this determination and drafted or shared in the drafting of other documents signed by DACO Olbrych (*see* tr. 1/46-47, 65, 116, 160-61, 249).

discontinuance of its prior practice of crediting Drag to its overhead pools was compliant with both the CAS and the FAR since January 1, 2005 (R4, tab 306 at 172). He also disagreed with the former DACO's determination that the difference between revenue share payments and MTC payments was immaterial in 2005. Based upon DCAA's September 22, 2011 192 audit report (finding 132) and information provided to him by Pratt on August 10, 2012 (finding 138), DACO Olbrych considered Pratt's CAS 418 noncompliance to be material to government contract pricing as of CY 2005 (R4, tab 306 at 173). In making the materiality determination, Mr. Hart confirmed, and appellant has not contested, that he and DACO Olbrych considered the FAR criteria on materiality and all of the factors in 48 C.F.R. 9903.305 (tr. 1/65-66, 71-73; ex. G-1). Moreover, we have found no evidence that the DACOs acted arbitrarily or capriciously or in bad faith or abused their discretion.

144. Between May 7, 2013 and DACO Olbrych's December 24, 2013 COFD determination that Pratt had violated CAS 418 (below), Pratt attempted to persuade the government that there was not a material difference between NRS and MTC. It added costs to be deducted from GRS, such as return on entry fees and post-certification costs, to the point that the resulting adjusted NRS was below MTC. (Tr. 1/271-72) Mr. Olbrych did not accept Pratt's contention that MTC was an acceptable surrogate for actual cost. He described a surrogate as a substitute or stand-in and "not the real deal" (tr. 1/277). He also disagreed with Pratt that the APA provided that MTC was an acceptable surrogate for actual costs, noting that the APA stated that Pratt was noncompliant with the CAS and that it should correct the noncompliance (*id*.).

145. Prior to the COFD, the DACO asked Pratt to submit information concerning its accounting changes and to revise them so that they would comply with CAS 418. Pratt did not offer any revisions nor did it submit any general dollar magnitude cost impact valuation of its alleged CAS 418 noncompliance as addressed in FAR 52.230-6(c). (R4, tab 328 at 178; tr. 1/291, 2/305-06; UGPFF 291)

146. On October 10, 2013, DACO Olbrych asked DCAA to prepare a ROM cost impact estimate, based upon the information available to it, resulting from Pratt's alleged noncompliance with CAS 418 from 2005 through 2012. DCAA did not have access to all of Pratt's pertinent records and could not reconcile the GRS figures in the Worthington report. It used the collaborator share of revenue as reported as a cost of sales in Pratt's annual audited financial statements for the period 2007-2012. (*See* R4, tab 326 at 2841; tr. 1/294-96, 2/308-09, 314)

147. On November 19, 2013, DCAA gave the DACO a ROM estimate of financial harm to the government from Pratt's alleged noncompliance with CAS 418 (R4, tabs 326, 328; tr.1/291-92, 2/307-08). It contained some errors, *e.g.*, when DCAA prepared the ROM, it did not know that Pratt's financial statements also covered Pratt & Whitney Canada and Pratt & Whitney Joint Ventures nor that the reported cost of sales

amount in the statements did not include FIA, Pratt's largest deduction from GRS, rendering the ROM understated (tr. 2/102-03, 323-25).

148. On December 24, 2013, Mr. Olbrych issued a COFD asserting a claim against Pratt for $210,968,414 (principal and interest). The COFD cited, *inter alia*, DCAA's September 22, 2011 192 audit report (finding 132); the DACO's September 28, 2011 notice of potential noncompliance with CAS 418 (finding 138); *Rumsfeld*, and the parties' June 5, 2006 Settlement Agreement and APA (findings 103-06), in support. The COFD alleged that the principal amount of the claim represented the cost to the government from Pratt's failure to comply with CAS 418 from January 1, 2005 through December 31, 2012:

> P&W's disclosed accounting practices do not correctly estimate the cost of its collaboration-supplied direct materials that comprise a portion of its material overhead base. P&W has been using MTC estimates in lieu of revenue share payments to cost its collaboration materials. *Revenue share payments represent the actual cost of collaboration-supplied parts per CAS 418-50(a)(2).* In considering this specific issue, the [Federal Circuit] defined the cost of collaboration material as revenue share payments. P&W began using MTC to estimate the cost of its collaboration materials on January 1, 2005 and has continued to use MTC to the present.

(R4, tab 334 at 182-83) (Emphasis added) As of the hearing, Pratt continued to use MTC in its Manufacturing Operations' material overhead pool (tr. 11/134).

149. The DACO made the following findings, among others, concerning Pratt's alleged noncompliance with CAS 418, and Drag:

> 7. Results from the [192] audit disclosed a substantial delta between either GRS or NRS and MTC. The cost impact of this delta was determined to be [redacted] in CY 2009. This is a material cost impact to Government contracts under 48 C.F.R. 9903.305 and FAR 30.602.
>
> . . . .
>
> 16. I find that P&W's use of MTC was noncompliant with CAS 418 from January 1, 2005, through December 31, 2012. *CAS 418-50(a)(2) requires a business unit to use actual costs in accounting for its direct costs*.

> 17. I find that gross revenue share is the cost of the collaborator parts.
>
> 18. I find that P&W's use of MTC has had a material cost impact upon Government contracts since January 1, 2005.
>
> 19. I find that the collaborator's share of Drag and other expenses needs to be removed from the applicable P&W overhead pools. This adjustment prevents P&W from a double-recovery of the collaborator's share of Drag and other expenses as indirect costs since they would already be recoverable as part of P&W's direct material cost on contract pricing actions.
>
> 20. I also find that the 2006 [APA] was not valid when it was entered and is not binding upon the Government.

(R4, tab 334 at 185-86) (Emphasis added) The COFD did not mention the FAR 31.201-5 Credit provision. DACO Olbrych confirmed, and appellant does not dispute, that, in making his materiality determination, he considered all of the criteria in 48 C.F.R. 9903.305 (tr. 1/258-59; UGPFF 302). Moreover, we have found no evidence that he acted arbitrarily or capriciously or in bad faith or abused his discretion.

150. Analogizing to other vendor situations, the DACO determined that it "made no sense" that Pratt was paying for items other than the purchased parts themselves (tr. 1/273). When revenue shares were booked to cost of sales, it seemed "pretty clear" what Pratt was paying for the parts (tr. 1/278). The collaborators were paying a share of Pratt's overheads. They transferred those costs to their books and accounted for them in their financial statements. The costs became the costs of the collaborators. They were paying Pratt for its costs. (Tr. 1/272, 281)

151. Pratt appealed from this COFD on March 18, 2014 and the Board docketed the appeal as ASBCA No. 59222, the appeal currently before us.[19]

[19] Pratt appealed from a COFD issued on December 18, 2018, which asserted a $307,910,177 government claim for Pratt's alleged noncompliance with CAS 418 from January 1, 2013 to December 31, 2017, due to its continued use of MTC in lieu of revenue share payments as the cost of collaborator parts. The Board docketed the appeal as ASBCA No. 61935 on January 11, 2019, and stayed it until the subject appeal has been decided.

Experts

We have cited above to evidence from the parties' experts largely for their factual information, not for any particular expertise. Additional evidence from the experts follows.

Ms. Sam Hadley

152. The government proffered Ms. Sam Hadley as an expert in accounting, cost accounting, GAAP, and the principles that apply under the FAR and the CAS. Appellant objected, *inter alia*, that the proffer was too broad. Said to be in view of *Rumsfeld*'s strictures, the government did not offer Ms. Hadley as an expert on CAS interpretation, rather on the application of the CAS in particular circumstances. The Board admitted her as an expert in government contract accounting, the FAR, GAAP and the CAS as they apply to the circumstances at hand, with any individual objections to be considered if raised. (Tr. 9/250-51, 253-54) Ms. Hadley's expert report is at R4, tab 400.

153. Ms. Hadley did not have prior experience with collaboration agreements involving the aerospace industry (tr. 9/237). However, based upon her review of relevant documents (*see* R4, tab 400, app'x B; tr. 10/8-10) and her knowledge of industry standards, Ms. Hadley opined that:

> 1. Margaret Worthington's August 2012 report is not reliable and does not support Pratt's use of MTC.
>
> 2. By definition, MTC is not an actual cost and has not been shown to be comparable to suppliers' part prices.
>
> 3. Based on the evidence provided, Pratt has not shown that revenue share payments include costs for items other than parts.
>
> 4. Pratt has the appropriate information and documentation to use revenue share instead of MTC.
>
> 5. The impact to the Government of using MTC instead of GRS, or an appropriate derivative, is significantly greater than Pratt has stated, and material to the amount of the overheard allocated to the government.

(R4, tab 400 at 3; *see* tr. 10/6-8, 167) In "appropriate derivative" Ms. Hadley included NRS, various definitions of revenue share and the like (tr. 10/8). Thus, in Ms. Hadley's expert opinion, Pratt's use of MTC rather than NRS had a significant impact upon the

government and was material to the amount of overhead allocated to government contracts. Similarly, DACO Olbrych found that there was a material cost impact upon government contracts due to Pratt's use of MTC rather than GRS or NRS (finding 149). Appellant's expert LeeVan acknowledged that, during the government's eight year claim period (2005-2012), material overhead allocated to government contracts using MTC was higher than an allocation using NRS (ex. A-385 at 77 ¶ 139). There is no persuasive evidence, for the relevant time period, that Pratt's use of MTC rather than NRS did not have a material impact upon costs it charged to government contracts.

154. Ms. Hadley found that Pratt's accounting summaries and correspondence defined MTC as an engineering estimate developed when Pratt negotiates program share with its collaborators (tr. 10/18-19). She opined that Pratt "has recognized MTC as an engineering estimate at learned out production, without the application of G&A and profit, to establish a price for the part" (R4, tab 400 at 11; tr. 10/18-19, 188). In "Manufacturing Target Cost," she identified the "T" in "Target" as "a target production cost, at optimal production value" (tr. 10/28; *see also* tr. 10/188). She described "learned out" as what one can produce the part for "once all the kinks have gotten out of the system" (*id.*). The parties get more efficient at producing a part over time, lowering production costs (tr. 10/30).

155. Ms. Hadley addressed a PW4000 Growth Engine Collaboration Agreement between Pratt [redacted], which defines MTC as follows:

> "Manufacturing Target Cost" or "MTC" means the estimated learned out total cost P&W would incur if P&W manufactured, procured or assembled the Engine or Part, including its material, labor, and manufacturing overhead.

(R4, tab 465 at 17151 ¶ 1.20; tr. 10/26-27) She relied in part upon the agreement's Appendix 10, Engineering Change Procedure, which defines MTC in essentially the same way:

> Manufacturing Target Cost (MTC) is the EV [Equivalent Value] of a Part, module or Engine (including Assembly & Test) in a particular year's economy, stated in U.S. dollars. It represents the estimated learned out total cost P&W would incur if P&W manufactured, procured or assembled the Engine or Part including its material, labor and manufacturing overhead.

(R4, tab 465 at 17258 ¶ 2.3; *see* tr. 10/27)

156. The Appendix states what is included in MTC in the context of the [redacted] and identifies several items that are excluded, such as G&A (R4, tab 465 at 17258 ¶¶ 2.7, 2.8; *see* tr. 10/27).

157. Ms. Hadley referred to a February 14, 2011 Pratt email on the subject of "Learning Curve Description," which attached a Pratt document entitled "PV's and Part MTC vs. Actual Production Costs" (R4, tab 216; tr. 10/30). That document states in part:

> PV = An agreed upon percentage of a part's value relative to the entire engine **irrespective of the part (or engine's) actual cost.** These percentages drive the economics of the partnership arrangement.
>
> Engine MTC = Manufacturing Target Cost is a notional value of engine cost. MTC escalates from a base value every year by a formula specified in the contract which is common for all program participants.
>
> Part MTC = PV * Engine MTC. Obviously, Part MTC escalates in the same fashion as engine MTC. It is a notional measure of the economic contribution of this part to the program. **It is unlikely that it is a good measure of the true cost of a part**.
>
> . . . .
>
> At the beginning of the program, actual cost is likely much higher than Part MTC. As a company builds more parts, the manufacturer comes down a learning curve and each part costs less and less to build . . . . Offsetting this learning is the natural inflation (labor and material costs) in manufacturing processes.

(R4, tab 216 at 266475) (Emphasis added) In this email Pratt was explaining the concept of MTC to a potential new collaborator (tr. 6/132-33).

158. Ms. Hadley defined "standard costing" as:

> [A] concept in cost accounting that, for ease in accounting, establishes a standard cost for things that it will distribute within the accounting system. One of the requirements in the [CAS] of using standard costing is that [the] discrepancy

> between actuals and standard then be disposed of or adjusted one way or another.

(Tr. 10/32) She opined that, contrary to standard costing, Pratt has not accounted for the differences between actual costs and MTC and disposed of, or reconciled, them in some manner (tr. 10/32-33).

159. Ms. Hadley pointed out that Pratt documentation expresses that MTC [redacted] (tr. 10/33, citing app. supp. R4 tab 136 at 163609 ¶ B).

160. Ms. Hadley noted that "Pratt's CAS disclosure statements define MTC as the 'notional cost value (manufacturing direct and indirect expenses, excluding [SG&A] and profit) of collaborator supplied parts'" (R4, tab 400 at 11).

161. Ms. Hadley found that MTC does not appear in Pratt's books and records, such as its general ledger, in Pratt's accounting system. The books and records do not accumulate MTC as a cost or a liability to the collaborators. (Tr. 10/17, 35, 149) "MTC would never hit the financials" (tr. 10/157).

162. According to Ms. Hadley, MTC is not a quantifiable amount contained within revenue share. Moreover Pratt established prices to the airframers that are not based upon a certain mark-up of MTC. (Tr. 10/36)

163. Ms. Hadley opined that MTC does not represent a "true cost" (tr. 10/156). It is an engineering estimate that does not include all of the cost. It is a method of insuring that all parties are using the same cost figure so they can calculate their revenue percentages. The parties are bound by the negotiated MTC regardless of actual cost. (Tr. 10/157-59) To Ms. Hadley, the most obvious factor that renders MTC not a true **cost** is the omission of G&A from its composition (tr. 10/27). MTC also does not include profit (tr. 10/172, 186-87, 189; *see also* tr. 6/203).

164. Regarding whether Pratt pays its collaborators GRS or NRS and which represents the cost of a part, Ms. Hadley stated that NRS is not an account in Pratt's accounting system. GRS and all expense recoveries are such accounts. NRS is just the mathematical result of all of the debits and credits in all of the other accounts. Ms. Hadley opined that the fact that expense recoveries were netted against GRS did not bear upon a part's cost and the use of "NRS" was an "oversimplification" and an "accounting convenience." (R4, tab 400, at 14-15; tr. 10/61-62, 68-69; *see also* tr. 1/68-69 (per Mr. Hart, NRS is not a "real number" and deduction of a collaborator's debts to Pratt from Pratt's payments to the collaborator makes no sense "other than for the ease of payment."))

165. Ms. Hadley expressed that collaborator payments or obligations to Pratt for expense recoveries can reduce the cost of a part, depending upon the collaboration agreement and the particular expense recovery involved (tr. 10/69-70; *see* R4, tab 400 at 16-19).

166. Concerning Drag, Ms. Hadley cited a January 23, 2013 letter from Ms. Lazinsk to DACO Olbrych that identified the types of expenses that each collaborator's Drag covered. All of the agreements included material handling in Drag. Production and material handling is part of the manufacturing overhead pool. In prior years, Pratt would credit that overhead pool with the amounts recovered from the collaborators. This reduced the material overhead rate. (R4, tab 288; tr. 10/76-78) Also, this would ensure that the costs for which Pratt had been paid were not distributed to the final cost objectives, whether they be commercial or government (tr. 10/212). Ms. Hadley concluded that "Drag is definitely related to typical items of cost" (tr. 10/209).

167. Regarding the financial impact to the government of using MTC versus GRS in the manufacturing overhead base, Ms. Hadley referred to a May 4, 2006 email from Ms. Lazinsk to DCAA Senior Auditor Hart on the subject (R4, tab 116). Ms. Hadley found the email's analysis of a [redacted] impact, using 2005 data, to be deficient because, like Ms. Worthington's analysis, it did not apply G&A and profit, which had the effect of understating the impact by [redacted] in Ms. Hadley's opinion (*id.* at 10048; tr. 10/102-05).

168. Ms. Hadley noted that Christine Bastien-Williams, then a contractor for Pratt and later a Pratt financial specialist (tr. 9/186-88), had done an internal impact analysis in May 2013 for Mr. Nisbet. It included G&A and showed a [redacted] impact to the government from Pratt's use of MTC versus GRS (R4, tab 308 at 42326; tr. 10/104-05). This was "significantly higher" than the Worthington and Lazinsk calculations (tr. 10/105-06).

169. Ms. Hadley defined NRS as GRS less FIA, Drag and other expense recoveries. She disagreed with Ms. Worthington that NRS includes payment for items other than parts. (Tr. 10/134, 138)

170. Ms. Hadley found that the over/under settlement process [redacted] tr. 10/50-52).

171. Ms. Hadley reaffirmed the statement in her report that Pratt has not shown MTC to be comparable to suppliers' part prices. She disagreed with a contrary

conclusion in a DCAA work paper, which she distinguished. (App. supp. R4, tab 136; tr. 10/168-70) She found that the work paper supported that MTC values were clearly not actual costs in that they were reported, in her words, as "wildly different" (tr. 10/171, citing app. supp. R4, tab 136 at 163609 ¶ 3). She also noted that the work paper demonstrated that actual cost information was available (tr. 10/171). Ms. Hadley believes it is possible to determine Pratt's actual costs and the true impact to the government of using MTC instead of actual costs, given the data and knowledge of Pratt's employees. Pratt has already identified the types of costs it incurs. (R4, tab 288 at 1870; tr. 10/209, 223)

172. Ms. Hadley opined that MTC is not the cost of a part; the actual value is the amount paid to collaborators based upon revenue share (tr. 10/190).

Ms. Cheryl LeeVan

173. Appellant proffered, and the Board accepted, Ms. Cheryl LeeVan as an expert in long term contracting and aerospace industry accounting, economics, operations and contract administration, Pratt's collaboration practices, financial forensics, GAAP, and regulations governing federal contracts, including the application and practice of the FAR cost principles and the CAS, as detailed in appellant's March 11, 2019 letter to the Board (tr. 11/15-16). Her expert report is contained at ex. A-385.

174. Ms. LeeVan addressed MTC in her expert report summary as follows:

> Each collaboration agreement is separately negotiated between Pratt and the collaborator, along with contractual/financial terms of the agreement. As described in the [redacted] Collaboration Agreement, [MTC] is the estimated learned out total cost Pratt would incur if Pratt manufactured, procured or assembled the engine or part, including its material, labor, and manufacturing overhead. As a result of negotiations with collaborators, MTC is the arms-length negotiated price for the collaborator supplied parts.

(Ex. A-385 at 7)

175. Regarding whether Pratt pays GRS or NRS to collaborators, Ms. LeeVan determined persuasively that it pays NRS:

> Even though Pratt agrees to share a portion of the program revenue with the collaborator over the life of the program, Pratt does not pay the collaborators [GRS], and the revenue share payments to collaborators are significantly less than

> GRS. Pratt makes a variety of deductions from GRS to determine [NRS], which it pays to the collaborators. I performed an analysis of wire payments to collaborators. My analysis of the wire payment documentation demonstrates that revenue share payments to collaborators are consistent with NRS.

(Ex. A-385 at 7)

176. In her report, the NRS Ms. LeeVan used from collaboration account summaries reflected GRS less FIA, Drag and the program expenses (tr. 11/184).

177. Concerning the differences in overhead allocation between using MTC and revenue share payments made to collaborators, which appellant described as NRS, Ms. LeeVan concluded that, using the CAS materiality criteria, based upon her analysis for the 2005-2017 time period, the difference was immaterial from an accounting perspective (tr. 11/116). She did not express any opinion concerning cost impact materiality during the 2005-2012 time period (tr. 11/200-01).

178. Ms. LeeVan did not agree with the government's position that GRS is the cost of the parts (tr. 11/66). She opined that FIA, in particular, was a substantial amount and not related at all to a part cost (*id.*).

179. Ms. LeeVan opined that revenue share payments to collaborators, or NRS, include more than payment for parts. According to her, the payments include pre-certification expenses and entry fees, in-kind post-certification engineering, risk and the collaborators' return on investment, which she did not quantify. (Ex. A-385 at 7-8; app. demonstrative ex. 13 at 13-14; *see also* tr. 11/24, 26-27, 43-44) However, she acknowledged that collaboration agreements typically provide that pre-certification expenses and entry fees are non-refundable. She stated, without citation to evidence, that collaborators nonetheless would expect to recoup their investments and to have a return on investment through revenue share payments (ex. A-385 at 52 ¶ 92, 60-61 ¶¶ 107-08). Ms. LeeVan also opined that it was not correct to measure the impact to the government by the use of GRS versus MTC because "GRS reflects payments for a lot more than parts" (tr. 11/111).

180. Ms. LeeVan noted that Pratt uses MTC [redacted]. She found that the practical advantages of using MTC cited by DACO Ennis in 2006 were still valid from an economic and accounting standpoint; and that the DACO's 2006 immateriality conclusion still applied in that the difference between using MTC and NRS in material overhead allocation continued to be immaterial in her view. (Ex. A-385 at 8; *see also* tr. 11/86-88)

181. Concerning Drag, Ms. LeeVan pointed out that, in 2006, the government concluded that Pratt's accounting change and treatment of Drag complied with the FAR and the CAS, if Pratt continued to include a cost for collaboration parts in its material base and the Drag provisions in the collaboration agreements did not materially change. She stated that Pratt has satisfied those conditions. (Ex. A-385 at 9 ¶ 19; tr. 11/133-34)

182. In her work Ms. LeeVan did not see any reconciliation of Drag recoveries to any particular cost in an overhead pool (tr. 11/136).

183. Ms. LeeVan concluded that, regardless of whether Pratt was required to use a measure other that MTC, the government's demand in the COFD at issue was overstated. The government's alleged errors included:

1) improper use of sales in the material overhead base, and
2) inaccurate [redacted]

(Ex. A-385 at 9)

184. In certain of Ms. LeeVan's analyses she used data from 2005-2017 and 2009-2017 (tr. 11/94-96, 103, 116, 184, 200). The periods beyond 2012 are outside the scope of the 2005-2012 period at issue.

185. Ms. LeeVan acknowledged that, other than in the context of "over/under" settlement situations, Pratt does not pay MTC to collaborators as the price of parts and that revenue share is not the same thing as MTC (tr. 11/163).

186. Ms. LeeVan acknowledged that Pratt does not pay FIA, Drag, or program expenses to collaborators (tr. 1/210-13).

Summary Findings

187. Pratt does not pay a collaborator's share of program expenses. All of the collaborators' expense obligations under the collaboration agreements are paid by the collaborators – not by Pratt. (Tr. 6/107-14, 7/247-48, 8/310, 11/210-13) There is no evidence that revenue share payments include any amount for return on investment. In fact, in calculating revenue share payments, Pratt does not include an amount for return on investment or return on entry fee (finding 72). The weight of the persuasive evidence, including Ms. Hadley's expert analysis (finding 153), establishes, and we find, that

Pratt's revenue share payments to collaborators do not include payment by Pratt for any items other than parts (or for services integral to providing the parts).

188. Pratt pays NRS to collaborators, not GRS (*see* findings 56, 129-131, 175, 179).

CAS AND FAR PROVISIONS PERTAINING TO COST ISSUES

CAS Provisions Relevant to Pratt's Use of MTC

CAS 401, Consistency in Estimating, Accumulating and Reporting Costs, provides at paragraph (a) (2) of CAS 401-30, Definitions, that:

> *Actual cost* means an amount determined on the basis of cost incurred (as distinguished from forecasted cost), including standard cost properly adjusted for applicable variance.

48 C.F.R. 9904.401-30(a)(2).

CAS 407, Use of Standard Costs for Direct Material and Direct Labor, provides at paragraph (a) of CAS 407-30, Definitions, that:

> (8) *Standard Cost* means any cost computed with the use of pre-established measures.
>
> (9) *Variance* means the difference between a pre-established measure and an actual measure.

48 C.F.R. 9904.407-30(a)(8)-(9). It defines "actual cost," at paragraph (b)(1), as "[a]n amount determined on the basis of cost incurred." 48 C.F.R. 9904.407-30(b)(1).

CAS 410, Allocation of Business Unit General and Administrative Expenses to Final Cost Objectives, cited by the DACO in his final decision at issue, as explained in CAS 410-20, Purpose:

> [Provides] criteria for the allocation of business unit [G&A] expenses to business unit final cost objectives based on their beneficial or causal relationship. These expenses represent the cost of the management and administration of the business unit as a whole. The Standard also provides criteria for the allocation of home office expenses received by a segment to the cost objectives of that segment. This Standard will

> increase the likelihood of achieving objectivity in the allocation of expenses to final cost objectives . . . .

48 C.F.R. 9904.410-20.

Under paragraph (a) of CAS 410-40, Fundamental Requirement, "[b]usiness unit G&A expenses shall be grouped in a separate indirect cost pool which shall be allocated only to final cost objectives." 48 C.F.R. 9904.410-40(a).

CAS 418-40, Fundamental Requirements, provides at paragraph (c) that: "[p]ooled costs shall be allocated to cost objectives in reasonable proportion to the beneficial or causal relationship of the pooled costs to cost objectives . . . ." 48 C.F.R. 9904.418-40(c).

Paragraph (a)(2) of CAS 418-50, Techniques for Application, relied upon by the DACO in his final decision at issue, provides in part that:

> (a) Determination of direct cost and indirect cost.
>
> . . . .
>
> (2) In accounting for direct costs a business unit shall use actual costs, except that –
>
> (i) Standard costs for material and labor may be used as provided in 9904.407 . . . .

48 C.F.R. § 9904.418-50(a)(2).

CAS 418-50(d), cited by DCAA in is audit reports (findings 82- 83), provides in part:

> (d) Allocation measures for an indirect cost pool which includes a material amount of the costs of management or supervision of activities involving direct labor or direct material costs.
>
> . . . .
>
> (2) The base used to represent the activity being managed or supervised shall be determined by the application of the criteria below. All significant elements of the selected base shall be included.

. . . .

(iv) A material cost base is appropriate if the activity being managed or supervised is a material-related activity.

48 C.F.R. 9904.418-50(d)

CAS 418-50(e) provides in part:

(e) Allocation measures for indirect cost pools that do not include material amounts of the costs of management or supervision of activities involving direct labor or direct material costs. Homogeneous indirect cost pools of this type have a direct and definitive relationship between the activities in the pool and benefiting cost objectives. The pooled costs shall be allocated using an appropriate measure of resource consumption. This determination shall be made in accordance with the following criteria taking into consideration the individual circumstances.

48 C.F.R. 9904.418-50(e)

CAS and FAR Provisions Relevant to Materiality

CAS 418-50, paragraph (c), Change in Allocation Base, provides in part that "[t]he determination of materiality shall be made using the criteria provided in 9903.305." 48 C.F.R. 9904.418-50(c). Subpart 9903.305 provides:

In determining whether amounts of cost are material or immaterial, the following criteria shall be considered where appropriate; no one criterion is necessarily determinative:

(a) The absolute dollar amount involved. The larger the dollar amount, the more likely that it will be material.

(b) The amount of contract cost compared with the amount under consideration. The larger the proportion of the amount under consideration to contract cost, the more likely it is to be material.

(c) The relationship between a cost item and a cost objective. Direct cost items, especially if the amounts are themselves

> part of a base for allocation of indirect costs, will normally have more impact than the same amount of indirect costs.
>
> (d) The impact on Government funding. Changes in accounting treatment will have more impact if they influence the distribution of costs between Government and non-Government cost objectives than if all cost objectives have Government financial support.
>
> (e) The cumulative impact of individually immaterial items. It is appropriate to consider whether such impacts:
>
> > (1) Tend to offset one another, or
> > (2) Tend to be in the same direction and hence to accumulate into a material amount.
>
> (f) The cost of administrative processing of the price adjustment modification shall be considered. If the cost to process exceeds the amount to be recovered, it is less likely the amount will be material.

48 C.F.R. § 9903.305.

In promulgating the CAS materiality criteria, now at § 9903.305, the CAS Board stated "the essence of materiality is to allow for the exercise of judgment. [The matter of cost impact] requires the exercise of judgment in the administration of the contracts involved and of the cost impact provisions prescribed by the acquisition agencies." 45 Fed. Reg. 8677 at 8678 (Feb. 8, 1980); 42 Fed. Reg. 54254 (Oct. 5, 1977) ("The essence of materiality criteria is to allow for the [exercise] of judgment . . . . ")

Paragraph (a) of FAR 30.602, MATERIALITY, provides that: "In determining materiality, the CFAO [Cognizant Federal Agency Official] shall use the criteria in 48 CFR 9903.305." Paragraph (c)(3)(ii) provides that: "If the noncompliance is not corrected, the Government reserves the right to make appropriate contract adjustments should the cost impact become material in the future." FAR 30.602(c)(3)(ii).

Paragraph (b)(4) of FAR 30.605, PROCESSING NONCOMPLIANCES, provides in part that "[i]f the CFAO makes a determination of noncompliance, the CFAO shall follow the procedures in paragraphs (c) through (h) of this section, as appropriate, unless the CFAO also determines the cost impact is immaterial."

FAR 52.230-6, ADMINISTRATION OF COST ACCOUNTING STANDARDS (APR 2005) provides in paragraph (c) that:

> When requested by the CFAO, submit . . . (1) A general dollar magnitude (GDM) proposal in accordance with paragraph (d) or (g) of this clause.

FAR Provision Relevant to Drag Issue

FAR 31.201-5, CREDITS, provides in relevant part:

> The applicable portion of any income, rebate, allowance, or other credit relating to any allowable cost and received by or accruing to the contractor shall be credited to the Government either as a cost reduction or by cash refund.

FAR Provisions Concerning Advance Agreements and Contracting Officer's Authority

FAR 31.109, ADVANCE AGREEMENTS, provides in part:

> (a) The extent of allowability of the costs covered in this part applies broadly to many accounting systems in varying contract situations. Thus, the reasonableness, the allocability and the allowability under the specific cost principles at subparts 31.2, 31.3, 31.6, and 31.7 of certain costs may be difficult to determine. To avoid possible subsequent disallowance or dispute based on unreasonableness, unallocability or unallowability under the [foregoing specific cost principles], contracting officers and contractors should seek advance agreement on the treatment of special or unusual costs . . . . However, an advance agreement is not an absolute requirement . . . .
>
> (b) Advance agreements may be negotiated either before or during a contract but should be negotiated before incurrence of the costs involved. The agreements must be in writing, executed by both contracting parties, and incorporated into applicable current and future contracts. An advance agreement shall contain a statement of its applicability and duration.

(c) The contracting officer is not authorized by this 31.109 to agree to a treatment of costs inconsistent with this part.

FAR 33.210, CONTRACTING OFFICER'S AUTHORITY, provides in part that "[e]xcept as provided in this section, contracting officers are authorized, within any specific limitations of their warrants, to decide or resolve all claims arising under or relating to a contract subject to the [CDA] . . . ."

THE PARTIES' CONTENTIONS[20]

The Government's Contentions

Among other things, the government contends that MTC is not an actual cost and Pratt's use of MTC in connection with its purchase of collaborators' engine parts, in lieu of actual cost, violates CAS 418(d), which requires Pratt to use "actual costs" in its direct material cost base. The government asserts that Pratt does not pay MTC to buy parts; it pays revenue share. The government alleges that the GRS attributable to the parts at the time of their production is the cost of the parts that Pratt pays to the collaborators.

The government asserts that Pratt failed to meet its burden under *Rumsfeld* to show that some portion of the revenue share payments by Pratt to collaborators were payments for items other than parts. The government alleges that, except for some minor services, the only items Pratt purchased with revenue shares were parts and Pratt obviously does not pay the program share of expenses that a collaborator owes to Pratt.

The government further contends that Pratt's claim that "revenue share" is only the net cash it wires to collaborators is "frivolous" (gov't br. at 85) and Pratt has no basis for reducing GRS by netting down the wired amount to cover the expenses a collaborator owes to Pratt. The government elaborates:

> Netting accounts payable (gross revenue share) and accounts receivable (collaborator share of expenses) in sending cash to collaborators is a matter of accounting convenience or "cash management." Pratt merely reduces the amounts of cash Pratt and the collaborators would send to each other. These reimbursements do not reduce the collaborator share of revenue recorded in the income statement or accounts payable in Pratt's general ledger (and its financial statements). Pratt's

[20] We have considered all of the parties' contentions, whether or not we mention or address them.

> economic obligation to the collaborator for the parts remains gross revenue share.

(Gov't br. at 85-86) (citations omitted)

Additionally, according to the government, the only other "items other than parts" that Pratt claims were included in revenue share payments to collaborators are imaginary or hypothetical concepts that lack any basis in the collaboration agreements (gov't br. at 86). This includes Pratt's claim that revenue share payments include payments for return on investment or return on entry fees and the like. Moreover, the government alleges that, contrary to Pratt's contention that it cannot do so, it can and must assign "revenue share" based upon the cost of collaboration parts when they are used during production (gov't br. at 88).

The government further asserts that the DACOs acted within their discretion and did not abuse that discretion, or violate any statute or regulation, in finding that Pratt's CAS 418 violation for the years 2005 through 2008 materially impacted the costs allocated to government contracts (gov't br. at 91). The government asserts that, contrary to Pratt's "frivolous" stance, the APA does not contain any numerical standard of materiality and does not establish materiality measurement guidelines (gov't br. at 97-98). The government also contends that "[i]t would be legal error for the Board to substitute its own view of materiality (much less Pratt's opinions) for that of the DACOs" (gov't br. at 100); an abuse of discretion review standard applies; and a *de novo* review by the Board of the DACOs' exercise of their discretion would be invalid (*see, e.g.*, gov't br. at 93, 108). Also, as part of its materiality discussion, the government, in effect, renews its LeeVan and its Engine Programs motions *in limine* (below).

Next, the government states that, until January1, 2005, Pratt credited Drag reimbursements to its indirect cost pools. As of the APA, it changed its practice and failed to credit Drag reimbursements to the indirect material overhead cost pools to which they were charged. The government alleges that this violates FAR 31.201-5, CREDITS. The government elaborates that Pratt is compensated for its Drag expenses by its collaborators, but also charges those expenses to the government through its indirect material overhead cost pool and thus is paid twice for the same expenses. The government asserts that the APA's "permission to allow Pratt to not credit DRAG payments, in direct violation of the Credits provision, is null and void" (gov't br. at 115).

In that vein, the government contends that the APA is unlawful and invalid. The government alleges that: (1) the APA is not supported by consideration; (2) the APA must be construed as separate from the Settlement Agreement due to the Settlement Agreement's integration clause and that neither agreement refers to the other; (3) because the APA is not ambiguous, the Board cannot consider extrinsic, or parol, evidence in interpreting it; and (4) the APA violates the law. (Gov't br. at 116-20)

Regarding the latter contention, the government alleges that, on its face, the APA violates several of FAR 31.109's mandatory provisions concerning advance agreements, including purporting to permit Pratt to treat costs in violation of the Credits clause. The government further contends that Pratt is construing the APA to grant it a right in perpetuity to use MTC as the cost of collaboration parts in its allocation base, which the agreement does not support and which violates the FAR, the CAS, and *Rumsfeld*. In fact, the APA requires Pratt to correct its CAS noncompliance and to compensate the government for its noncompliant use of MTC, if and when the government determines that Pratt's noncompliant practice is material. Lastly, the government alleges that the APA lacks any limit on its applicability or duration and there is no evidence that it was incorporated into any contracts, both failures being in violation of FAR 31.109(b). (Gov't br. at 120-24)

Appellant's Contentions

Among other things, appellant contends that its use of MTC complies with CAS 418 and *Rumsfeld* and while "[t]here is no dispute that this appeal is governed by [*Rumsfeld*]," contrary to the government's argument, the court did not already decide the issues currently before this Board (app. br. at 77). Appellant describes the issue in *Rumsfeld* as "***whether*** Pratt was required to include a cost for collaboration parts in its overhead allocation bases," which the court decided it was required to do. (app. br. at 77) (emphasis in original). However, appellant characterizes the issue now before the Board as defining that cost.

Appellant stresses that:

> Importantly, the Federal Circuit did not hold that the revenue share payments—much less gross revenue shares—***are*** the cost of the collaboration parts; it held that revenue share payments "comprise" or include costs for the parts. "Comprise" means "to include esp. within a particular scope." MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 256 (11th ed. 2012). . . . In the patent claim context, the Federal Circuit has held that the terms "comprise" and "comprising" are "inclusive or open-ended" and "broader than consist." *E.g., CIAS, Inc. v. All. Gaming Corp.*, 504 F.3d 1356, 1360–61 (Fed. Cir. 2007) (contrasting the terms "comprise" and "consist," explaining that ". . . 'comprising' . . . is inclusive or open-ended and does not exclude additional, unrecited elements or method steps . . ."). The Federal Circuit has expressed no conflicting

> interpretation of the meaning of "comprise" in the government contracts context.

(App. br. at 77-78) (emphasis in original) Appellant alleges that footnote 19 in *Rumsfeld* (finding 32) reflects the Federal Circuit's recognition that "revenue share payments may compensate collaboration partners for more than just parts" (app. br. at 78).

Appellant contends that the logical interpretation of *Rumsfeld* is that the phrase "revenue share payments" means revenue share paid to collaborators—that is, NRS. In fact, according to appellant, regardless of whether the starting point is GRS or NRS, the evidence establishes that revenue share payments include payments beyond those for collaboration parts, and that MTC constitutes the cost of those parts. (App. br. at 79)

Appellant alleges that the government did not prove that its use of MTC violates CAS 418 and that a change in accounting base was required by CAS 418(c). Appellant asserts that it complies with CAS 418 because it allocates its material overhead pool over a material cost base, as permitted by CAS 418-50(d)(2); "the activity being managed or supervised is a material-related activity" (CAS 418-50(d)(2)(iv)); and "MTC provides consistent, stable negotiated parts values that promote allocation of material overhead 'in reasonable proportion to the beneficial or causal relationship of the pooled costs to cost objectives' [CAS 418-40(c)]." (App. br. at 79)

Appellant asserts that "CAS 418 nowhere states that costs included in a material cost base for the allocation of indirect costs must be 'actual costs'" (app. br. at 81). It acknowledges that CAS 418 provides that "[i]n accounting for direct costs a business unit shall use actual costs," but it alleges that, because material overhead is not a direct cost, "it need not be allocated by use of actual costs" (*id*.).

Appellant contends that CAS interpretation is a question of law that the Board reviews *de novo* such that, contrary to the government's contention, the DACO's determination of materiality is not reviewed under an abuse of discretion standard (app. br. at 74).

Additionally, appellant contends that GRS is not the cost of the collaborator parts; the government has not met its burden to prove that it is entitled to a credit for Drag under FAR 31.201-5; and DACO Ennis acted within the scope of her authority in negotiating and executing the Settlement Agreement, the APA and the disposition notices, and the government is bound by each of them. Appellant further alleges that the Settlement Agreement and the APA are part of the same 2006 settlement and the APA is legally valid.

Appellant also alleges that the government breached the 2006 settlement in two respects. First, the portion of the government's CAS 418 claims that includes the cost

impact of the alleged noncompliance from January 1, 2005 through June 5, 2006, is barred by what appellant describes as the "release" in paragraph 5 of the APA and assertion of a CAS 418 noncompliance claim based upon Pratt's use of MTC as the cost of collaborator parts from January 1, 2005 through December 31, 2012 is "plainly contrary" to the "waiver" in paragraph 5 (see finding 108) (app. br. at 111-12).[21]

Second, the DACO allegedly breached the APA by asserting a CAS 418 claim without first satisfying the conditions of paragraph 4 of the APA (see finding 108), because he did not consider the materiality of any cost impact as compared to "revenue share payments." Rather he only made a comparison to GRS. He also failed to make a good faith effort to identify an appropriate portion of revenue share payments as the CAS compliant cost of collaborator parts, i.e., the portion of revenue share payments that was for "other than parts." (App. br. at 112)

Appellant also asserts that, as with its CAS 418 claims, the portion of the government's Drag credit claim covering the period from January 1, 2005 through June 5, 2006, is barred by the "release" in paragraph 5 of the APA. Appellant contends that, additionally, the entire Drag credit claim is barred by accord and satisfaction pursuant to paragraph 2 of the APA (*see* finding 108). Lastly, appellant asserts that all of the government's claims are barred by the CDA's statute of limitations.

The Government's Reply Brief Contentions

The government replies, *inter alia*, that: GRS is the cost of collaborator parts; MTC violates CAS 418 and *Rumsfeld*; MTC is not an actual cost as required by CAS 418; and appellant has not met its burden to prove that some portion of the revenue shares is payment for items other than parts (gov't reply br. at 43).

The government alleges that appellant misreads *Rumsfeld* and that appellant's reliance upon "the peculiar treatment of 'comprise' in patent cases is utterly misplaced" (gov't reply at 34).

The government disputes appellant's argument that CAS 418 does not require that

[21] Appellant discusses the Settlement Agreement in the context of whether there were separate agreements, and mentions the release in its paragraph 4 (*see* finding 105), but it does not appear to allege that this release bars the government's claims (app. br. at 107, 111). Accordingly, we do not address a release issue that was not raised.

costs included in a material cost base for the allocation of indirect costs be actual costs, as follows:

> Like all "allocation bases," Pratt's Direct Material Base allocates indirect costs. That its direct material cost base allocates indirect costs does not mean that the direct material cost in the base does not need to be "accounted for" using "actual costs." Subsection 50(a)(2) states that those direct material costs shall be accounted for using actual costs."

(Gov't reply at 37-38)

The government alleges that appellant's "actual cost" arguments are undermined by the fact that it never attempted to use, and never addressed, standard costing under CAS 401-30(a)(2) and CAS 407-30(a)(8), which constitutes an actual cost under CAS 418, and could have been used to estimate the cost of parts used during the time of production (gov't br. at 90-91; gov't reply br. at 39-40). The government asserts that, regardless, GRS is the actual cost of collaborator parts that complies with *Rumsfeld* and CAS 418. (Gov't reply br. at 40)

The government argues further that appellant's CAS 418 noncompliance is material; appellant violated the Credit cost principle by failing to credit Drag; and the APA, which the government characterizes as an advance agreement, is invalid and unenforceable (gov't reply at 46-57).

Lastly, the government asserts that the CDA's statute of limitations does not bar its claims. It adds that, even if it knew or should have known of a claim under CAS 418 more than six years prior to the COFD at issue, under the continuing claims doctrine, its claims for Pratt's continuing CAS 418 and FAR 31.201-5 violations within the six years preceding presentation are timely.

The government does not address appellant's waiver, release and accord and satisfaction arguments.

Appellant's Surreply Contentions

Appellant responds by disclaiming the government's arguments and expanding upon some of its own.

DISCUSSION

Preliminary Matters

We address the following matters first because they affect the scope of the evidence and the issues to be considered and decided.

Government's Motions *In Limine*

As summarized in the Board's January 28, 2020 Order, on May 21, 2019, the government filed a pre-hearing "Motion *In Limine* to Exclude the Expert Report and Testimony of Cheryl LeeVan" (LeeVan motion) and a "Motion *In Limine* to Exclude Evidence and Testimony Concerning Pratt's Engine Programs that Post Date 2012" (Engine Programs motion). The Board denied the LeeVan motion, as memorialized in its May 30, 2019 "Order on the Government's Motion to Strike and on Various of the Parties' Motions" (¶12). The May 30, 2019 Order deferred ruling on the Engine Programs motion until after the hearing (¶9).

On December 16, 2019, the government submitted a post-hearing "Renewed Motion *In Limine* to Exclude Evidence and Testimony, Including the Opinions of Cheryl LeeVan, Concerning Events that Post Date and Do Not Relate to the Relevant 2005 through 2012 Time Period." The motion renewed the LeeVan and Engine Programs motions. The Board's January 28, 2020 Order declined to re-visit its denial of the LeeVan motion but stated that it would address the Engine Programs motion in its decision on the merits.

The Board grants the government's Engine Programs motion to the extent that the Board has not considered testimony or other evidence that post-dates and does not relate to the 2005 through 2012 period relevant to this appeal. If it arguably does so relate we have considered it, whether or not we have relied upon it.

The Government's Claims are not Barred by the CDA'S Statute of Limitations

The CDA requires that:

> (A) In general. Each claim by a contractor against the Federal Government relating to a contract and each claim by the Federal Government against a contractor relating to a

> contract shall be submitted within 6 years after the accrual of the claim.
>
> (B) Subparagraph (A) of this paragraph does not apply to a claim by the Federal Government against a contractor that is based on a claim by the contractor involving fraud.

41 U.S.C. § 7103(a)(4)(A)-(B).

FAR 33.206, INITIATION OF A CLAIM, provides:

> (b) The contracting officer shall issue a written decision on any Government claim initiated against a contractor within 6 years after accrual of the claim, unless the contracting parties agreed to a shorter time period. The 6-year period shall not apply to contracts awarded prior to October 1, 1995, or to a Government claim based on a contractor claim involving fraud.

The CDA does not define "accrual" of a claim, but FAR 33.201, states:

> Accrual of a claim means the date when all events, that fix the alleged liability of either the Government or the contractor and permit assertion of the claim, were known or should have been known. For liability to be fixed, some injury must have occurred. However, monetary damages need not have been incurred.

An assertion that a claim is barred by the CDA's statute of limitations is not a jurisdictional issue but is an affirmative defense with regard to which the proponent bears the burden of proof. *Sikorsky Aircraft Corp. v. United States*, 773 F.3d 1315, 1322 (Fed. Cir. 2014); *Kellogg Brown & Root Services, Inc*., ASBCA No. 58175, 15-1 BCA ¶ 35,988 at 175,823.

Claim accrual is not necessarily suspended until the contracting party performs an audit or other financial analysis to determine the amount of its damages. *Sparton DeLeon Springs, LLC*, ASBCA No. 60416, 17-1 BCA ¶ 36,601 at 178,312; *Raytheon Missile Systems*, ASBCA No. 58011, 13-1 BCA ¶ 35,241 at 173,018. Moreover, claim accrual does not turn upon the date the contracting officer or other individual with authority to assert a claim has knowledge of it. Thus, a contracting party cannot delay the running of the statute of limitations by postponing an audit or keeping the claim information from an individual authorized to assert the claim. *See Raytheon Missile Systems*, 13-1 BCA ¶ 35,541 at 173,018.

The test for determining when the events that fix the alleged claim liability were known or should have been known includes a reasonableness component. *Supreme Foodservice GmbH*, ASBCA No. 57884 *et al*., 16-1 BCA ¶ 36,426 at 177,582 (citing *Kellogg Brown & Root Services, Inc*., 15-1 BCA ¶ 35,988 at 175,825). Claim accrual does not depend upon what a party subjectively understood; rather, "it objectively turns upon what facts are reasonably knowable." *Raytheon Missile Systems*, 13 BCA ¶ 35,241 at 173,017. "The events fixing liability should have been known when they occurred unless they can be reasonably found to have been either concealed or 'inherently unknowable' at that time." *Id.* Once a party is on notice that it has a potential claim, the statute of limitations can begin to run. *Gray Personnel, Inc.*, ASBCA No. 54652, 06-2 BCA ¶ 33,378 at 165,476[22]. In evaluating when the claimed liability was fixed, we first examine the legal basis of the claim. *Id*. at 165,475.

As indicated in FAR 33.206, the government asserts a claim through a contracting officer's decision. *See also Sikorsky Aircraft Corp.*, 773 F.3d at 1320. The COFD at issue is dated December 24, 2013 (finding 148). To be timely, the government's claims must have been asserted no more than six years after their accrual. Thus, if they accrued before December 25, 2007, they are not timely.

DCAA's September 22, 2011 192 audit report (finding 132), which had questioned Pratt's MTC accounting practices, was one of the bases for the COFD. The COFD alleged that "the [192] audit disclosed a substantial delta between either GRS or NRS and MTC"; the impact was over [redacted] in CY 2009; and this was a material cost impact to government contracts under 48 C.F.R. § 9903.305 and FAR 30.602 (R4, tab 334 at 185). The decision demanded $210,968,414 from Pratt on the basis that it had not complied with CAS 418 from January 1, 2005, through December 31, 2012. Rather than the required actual costs, it had used MTC estimates in lieu of revenue share payments to cost its collaboration materials in accounting for its direct costs, and the use of MTC had had a material cost impact upon government contracts since January 1, 2005. (Findings 148-49)

The COFD declared that GRS was the cost of collaborator parts. The COFD also claimed that Pratt's failure to remove the collaborators' share of Drag and other expenses from its overhead pools would cause a double recovery of those items as indirect costs because they were already recoverable as part of Pratt's direct material costs on contract pricing actions. The COFD also claimed that the APA was invalid and not binding upon the government. (Finding 148) Appellant does not focus upon the latter contention in its statute of limitations affirmative defense.

[22] The *Raytheon Missile Systems* and *Gray Personnel* cases were decided before *Sikorsky* held that the CDA's statute of limitations was not jurisdictional, but their relevant precepts still apply.

Appellant asserts that the government's CAS 418 claim is based upon the cost impact of its January 1, 2005 accounting practice change, which adopted the use of MTC as the cost of collaborator parts, and that the government's Drag claim is based upon appellant's January 1, 2005 discontinuance of its practice of allocating Drag credits to its indirect cost pools. Therefore, according to appellant, the question is, when did the government know, or reasonably should have known, that it had a basis to seek a cost adjustment because of what appellant describes as the accounting changes? (App. br. at 114)

Appellant contends that the government's claims accrued when DCAA issued its September 23, 2005 audit report opining that Pratt's use of MTC did not comply with CAS 418 and that its practice of no longer crediting Drag to its indirect cost pools violated FAR 31.201-5. Appellant alleges that the report found that the CAS 418 violations had a material cost impact upon the government. Appellant further contends that, at the latest, the government was aware of these issues when it executed the settlement documents on June 5, 2006. (Ap. br. at 115)

The government responds, among other things, that appellant has acknowledged that "'materiality is a required element of [a CAS 418] noncompliance, including in determining whether a contractor is required to change its existing allocation base'" (gov't reply br. at 59, quoting app. br. at 74). Therefore, according to the government, its claim under CAS 418 could not have accrued before the government knew, or should have known, that the impact resulting from Pratt's noncompliance was material. The government asserts that it was not until the July 27, 2010 forward pricing audit report (finding 128) that it first knew of a potential material impact and it was not until the September 22, 2011 192 audit report that it identified a material impact (finding 132). The government points out, as we have found, that the September 23, 2005 audit report relied upon by appellant did not make any materiality determination or mention materiality (finding 84).

Citing, *inter alia*, *Fluor Corp*., ASBCA No. 57852, 14-1 BCA ¶ 35,472, the government adds, *arguendo*, that, even if it should have known of its CAS 418 and FAR 31.201-5 claims more than six years before the COFD, a government claim for CAS noncompliance falls under the continuing claims doctrine, such that the portion of its claims that falls within the limitations period survives.

Appellant itself has posited that materiality is a required element of a CAS 418 violation. As of the June 5, 2006 settlement and APA agreements, the CACO had determined that, while noncompliant, appellant's use of MTC did not presently result in a material amount of increased costs to the government. However, the government reserved the right to make appropriate adjustments if the noncompliance became material in the future (finding 108). The September 23, 2005 audit report preceded the June 5, 2006 APA, which resolved the forward pricing issues through June 5, 2006 (finding 128) and the audit report did not mention materiality (finding 84).

While the government cannot deliberately delay the accrual of a claim by delaying an audit, for example, in the CAS compliance context, audits may well be essential before it can be determined whether the government has a claim. The government contends that it first knew of a potential material impact from appellant's CAS noncompliance upon the issuance of the July 27, 2010 forward pricing audit report. That report concluded that the noncompliance was "significant enough to materially impact the results of audit of the material overhead rate" and that the contracting officer should determine the impact of using MTC rather than revenue share payments in the proposed direct material allocation base (finding 128).[23]

We conclude, under *Gray Personnel*, 06-2 BCA ¶ 33,378 at 165,476, which refers to claim accrual upon notice of a potential claim, that the government's claim accrued not later than the July 27, 2010 forward pricing audit report, rather than the September 22, 2011 192 audit report cited in the COFD, which specifically found that appellant's alleged CAS noncompliance had a material impact upon its government contracts (findings 132, 136, 148). Regardless, the July 27, 2010 date of the audit report, or the June 28, 2010 receipt of data, were both well within the CDA's 6-year claim assertion limit.

In sum, appellant has not met its burden to prove its affirmative defense that the government's claims are barred by the CDA's statute of limitations. Because we conclude that they are not so barred, we do not reach the government's continuing claims argument.

The Settlement Agreement and the APA are Separate Agreements

Appellant's personnel and the government's personnel referred to the Settlement Agreement and the APA, at various times, as a single agreement or as separate agreements. However, with one unclear exception (*see* finding 102), the government consistently referred to them as separate agreements and revised a Pratt settlement agreement draft to call for separate agreements (*see, e.g.*, findings 100, 111, 122-25).

Regardless, neither party claims that the Settlement Agreement or the APA is ambiguous. Under the circumstances, when the provisions of an agreement are clear and unambiguous, they must be given their plain and ordinary meaning and a tribunal may

[23] The government was arguably aware of a potential claim as early as January 4, 2005. *See* finding 67 concerning Hart report. However, the July 27, 2010 audit report notes that Pratt had not provided NRS amounts in its proposal and that the auditors had requested MTC and NRS amounts as part of the audit. Certain of the requested data were not provided until June 28, 2010. *See* finding 128. The government argues that this information was necessary for the government to determine materiality of the potential CAS 418 claim (gov't reply at 58-59). Pratt did not respond to the government's argument.

not resort to extrinsic evidence to interpret them. *Coast Federal Bank, FSB v. United States*, 323 F.3d 1035, 1040 (Fed. Cir. 2003) (*en banc*).

The government relies upon the integration clause in the Settlement Agreement, which provides that the "Agreement is the entire Agreement between the Parties, and supercedes any prior agreements" (finding 105 ¶ 10), to bar appellant's contention that the Settlement Agreement and the APA must be read together as part of the same agreement. The government contends that the clause refers to contemporaneous as well as prior agreements. (Gov't reply br. at 55-56) However, the integration clause refers only to prior agreements. Nevertheless, the Settlement Agreement and the APA, while executed at the same meeting (finding 102), do not refer to each other (finding 125). They record separate transactions and are not ambiguous.

The Settlement Agreement and the APA are clearly separate agreements.

The APA is a Valid Agreement

Appellant contends that the APA is not an advance agreement, even though, contemporaneously, Pratt drafted and referred to the agreement as an advance agreement (findings 95, 100). While the APA states that it was under the authority of FAR 31.109, ADVANCE AGREEMENTS (finding 106), the government notes correctly that the APA does not satisfy the requirements of an advance agreement, including that it be incorporated into applicable current and future contracts and that it "shall contain a statement of its applicability and duration." FAR 31.109(b). We have not been directed to any evidence that the APA was incorporated into any of Pratt's government contracts and it was not incorporated into the captioned contract. We find no statement in the agreement specifying its duration. (Finding 109)

Regardless, as we pointed out in *Paradigm II, LLC, d/b/a JB Carpet & Upholstery Care*, ASBCA No. 55849, 09-1 BCA ¶ 34,070 at 168,464:

> The determination of a contract type is a matter of law, *Maintenance Engineers v. United States*, 749 F.2d 724, 726 n.3 (Fed. Cir. 1984), and we are not bound either by what the contract is called or by the label attached to it by the parties. *Mason v. United States*, 615 F.2d 1343, 1346 (Ct. Cl.), *cert. denied*, 449 U.S. 830 (1980).

The elements of a valid contract are:

> 1) a mutual intent to be bound; 2) an unambiguous offer and acceptance; 3) consideration; and 4) actual authority on the part of the government representative to bind the government.

Ruby Emerald Constr. Co., ASBCA No. 61096, 18-1 BCA ¶ 37,197 at 181,084. The government principally challenges that the APA satisfies elements 3), consideration, and 4), authority to bind the government.

"Consideration is 'a bargained for exchange consisting of an act, forbearance, or return promise.'" *Ruby Emerald,* 18-1 BCA ¶ 37,197 at 181,086 (citations omitted). The APA is based upon the following premises:

> WHEREAS, the parties have determined it is in their best interests to resolve the 2005 Forward issues through the date of this agreement and to agree upon the prospective use of the practices at issue;
>
> NOW, THEREFORE, in consideration of the promises herein, the parties agree as follows:

(Finding 107)

Through the APA the parties settled the "2005 Forward issues" addressed in DCAA audits, which pertained to Pratt's accounting for commercial collaboration agreements, including, as relevant to this appeal, Pratt's discontinuance of its practice of crediting Drag to its overhead pools and its use of MTC as the cost of collaboration parts. DCMA agreed that it would not require Drag credits prospectively, provided that Pratt continued to include a cost for collaboration parts in its allocation base(s) and that the Drag provisions of the collaboration agreements did not materially change. Additionally, if the government later found the cost impact of Pratt's use of MTC to be material, Pratt agreed to engage in a "good faith effort" with the government to identify a CAS-compliant cost measure. (R4, tab 128 at 115; findings 107-08) These were promises and mutual forbearances by the parties. Lastly, the APA was backed by the general consideration of aiming to avoid the costs of litigation over the 2005 Forward issues.

In sum, the APA was supported by consideration.

Regarding DACO Ennis' authority to execute the APA, contrary to the government's current position, both Pratt and the government declared contemporaneously that she was authorized to execute it (tr. 7/116, 10/267; findings 106-07, 120-21; *see* FAR 33.210). The government has not come forward with any evidence that she was not authorized (finding 120). No question has been raised about Mr. Nichols' authority to sign on behalf of Pratt (finding 121).

The government now alleges that, by executing the APA, DACO Ennis violated FAR 31.205-1 concerning the allocation of credits to the government, FAR 30.602(c) and 30.605(b)(4) concerning MTC, and FAR 31.109(b) concerning advance agreements (gov't br. at 120-24). There was no firm consensus among government personnel as to whether FAR violations had occurred. Regarding Drag credits, for example, DCAA auditor, Ms. Marianne Hart, first opined internally in 2005 that in order for the government to share in the credits, it must prove that the overhead expenses were allocated to government contracts. Although she changed her view concerning the burden of proof during the hearing, she still held this view at the time of her 2010 OIG interviews. She noted that, while the government had concluded that Drag credits should stay in the overhead pool, it did not test to see if Drag applied to any costs that had been allocated to government contracts and reimbursed by the government. (Findings 78-80) In fact, in her work, appellant's expert, Ms. LeeVan, did not see any reconciliation of Drag recoveries to any particular cost in an overhead pool (finding 180).

The government bears the burden to prove that it overpaid appellant and is entitled to a credit. *Alaska Aerospace Corp*., ASBCA No. 59794, 16-1 BCA ¶ 36,498 at 177,843. It has not met that burden.

The government also has not established that DACO Ennis lacked authority to settle the disputed MTC issues. Moreover, while the APA did not meet all of the FAR criteria for advance agreements (*see* FAR 31.109; finding 109), this does not mean that it was not otherwise a legitimate agreement. The fact that the government changed its view and now disagrees with the DACO's positions, as expressed in the APA and concurred in by her superior, Mr. Leahy (finding 121), does not render the APA invalid.

In sum, the APA was a legitimate agreement.

The Portion of the Government's CAS 418 Claims Covering the Period from January 1, 2005 through June 5, 2006, is Barred by Waiver

Appellant raises the affirmative defenses that the government's claims are barred by waiver, release and accord and satisfaction. Appellant has the burden to prove its affirmative defenses. *The Ryan Co*., ASBCA No. 58137, 15-1 BCA ¶ 35,998 at 175,860. "Waiver occurs when a party intentionally relinquishes a known right." *Chugach Federal Solutions, Inc.*, ASBCA No. 61320, 19-1 BCA ¶ 37,314 at 181,496 (citation omitted). "A release is a contract whereby a party abandons a claim or relinquishes a right that could be asserted against another." *Holland v. United States*, 621 F.3d 1366, 1377 (Fed. Cir. 2010) (citation omitted).

In paragraph 5 of the APA, the government stated explicitly that it "waives its right to any cost impacts or interim or final rate changes relating to the 2005 Forward issues" through June 5, 2006, the date of the APA (finding 108). Those issues pertained

to questions raised in audit reports concerning Pratt's accounting for commercial collaboration agreements "effective January 1, 2005 forward" (finding 107). Although appellant refers to paragraph 5 as containing a "release" (app. br. at 112), the paragraph employs the term "waives" but does not mention "release" (finding 108).

In sum, the portion of the government's CAS 418 claims covering the period from January 1, 2005 through June 5, 2006, is barred by waiver. While appellant's citation to a release in the APA appears to be unsupported, we need not address this question (*see* n.21 above).

The Government's Entire Drag Credit Claim is Barred by Accord and Satisfaction

Appellant additionally contends that the government's entire Drag credit claim is barred by accord and satisfaction pursuant to APA paragraph 2. An accord and satisfaction occurs when "a claim is discharged because some performance other than that which was claimed to be due is accepted as full satisfaction of the claim." *Holland*, 621 F.3d at 1377. The party asserting the affirmative defense of accord and satisfaction has the burden of proving: (1) proper subject matter; (2) competent parties; (3) a meeting of the parties' minds; and (4) consideration. *Optex Systems, Inc*., ASBCA No. 58820, 14-1 BCA ¶ 35,801 at 175,097 (citing *Holland*, 621 F.3d at 1382).

APA paragraph 2 states:

> 2. The Disposition Notices and Letter also conclude that Pratt's discontinuance of its prior practice of crediting DRAG to its overhead pools was compliant with both CAS and the [FAR] from January 1, 2005 to the [June 5, 2006] date of this agreement. The Government will not require such credits prospectively, provided that Pratt continues to include a cost for collaboration parts in its allocation base or bases and that the "DRAG" provisions of the collaboration agreements do not materially change.

(Finding 108)

APA paragraph 3 provides:

> 3. The Disposition Notices, the Letter, and this Agreement **resolve** the 2005 Forward [redacted] and DRAG credit issues. The Government shall take no further action on the audit reports addressing these issues, and the DACO hereby withdraws any

> and all interim or final findings of noncompliance arising under or related to these issues.

(*Id*.) (Emphasis added)

APA paragraph 5 states:

> 5. The Government waives its right to any cost impacts or interim or final rate changes relating to the 2005 Forward issues through the date of this Agreement, whether arising under or related to savings provisions in Pratt's CAS-covered contracts or otherwise.

(*Id*.)

APA paragraph 7 states:

> 7. Nothing in this Agreement shall be construed as limiting (a) the Government's right and obligation to periodically review Pratt's accounting practices for adequacy and CAS compliance and to make determinations regarding such adequacy and compliance based on the facts and circumstances present at the time of such reviews and the laws and regulations then in effect; or (b) any audit right granted by law, regulation or any contract provisions.

(*Id*.)

APA paragraph 8 declares:

> 8. This Agreement is in accord and satisfaction of the 2005 Forward issues to the extent stated in paragraphs 1 through 5 above.[24] It shall extend to and be binding upon the parties hereto and their respective agents, successors and assigns to the extent permitted by law and regulation.

(*Id*.)

The government has not presented evidence that any CAS changes, or any new questions concerning appellant's accounting practices or CAS compliance have occurred.

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[24] We have quoted here the paragraphs relevant to the Drag issue. The other paragraphs are quoted at finding 108.

In fact, the unrebutted testimony of appellant's expert, Ms. LeeVan, was that appellant has satisfied paragraph 2's conditions for the government's continuing not to require it to credit Drag to its overhead pools (finding 181-82).

We have found that there was consideration for the APA agreement, DACO Ellis was authorized to enter into it, and the APA was a valid agreement. The government has not challenged that there was a meeting of the parties' minds. We conclude that appellant has met its burden to prove that an accord and satisfaction occurred.

Therefore, the government's entire Drag credit claim is barred by accord and satisfaction.

The Government Did Not Breach the APA

The APA states the government's position that Pratt's use of MTC as the cost of collaboration parts does not comply with the CAS, but that this did not presently result in a material amount of increased costs to the government, such that no contract adjustments were then required. However, the government reserved the right to make adjustments should the noncompliance become material. If it became material, when compared to using revenue share payments as the cost of collaboration parts, the parties agreed to make a good faith effort to identify a portion of revenue share payments as the CAS-compliant cost of collaboration parts or to identify another CAS-compliant means of addressing collaboration parts. (Finding 108)

Prior to the COFD at issue, in its July 27, 2010 forward pricing audit report, DCAA advised that Pratt's continuing noncompliance with CAS 418 was "significant enough to materially impact the results of audit of the material overhead rate" (finding 128). The report recommended that contract price negotiations concerning the material overhead rate await the contracting officer's consideration and determination of the impact of using MTC rather than Revenue Share Payments in the proposed direct material allocation base (*id*.).

In its September 22, 2011 192 noncompliance audit report, DCAA stated that Pratt's use of MTC in place of actual costs did not comply with CAS 418-50(a)(2) because the amounts were not Pratt's actual direct material cost for collaboration parts. DCAA concluded that this had a material impact upon material overhead expense allocated to government contracts. (Findings 132, 134)

Thereafter the parties engaged in good faith discussions on the disputed issues and Pratt provided extensive amounts of information, including expert reports, on the question of whether gross revenue share payments included payments beyond that for collaboration parts. The parties also addressed the issue of the materiality of the alleged CAS 418 noncompliance and its impact. DACO Olbrych also considered ROM cost

impact estimates from DCAA concerning Pratt's alleged CAS 418 violation. (Findings 138-40, 143-47)

Contrary to appellant's contention that the Board does not review the DACOs' materiality determinations under an abuse of discretion standard, a contracting officer's determination of whether a cost impact is material involves judgment and discretion. ("[T]he essence of materiality is to allow for the exercise of judgment. [The matter of cost impact] requires the exercise of judgment in the administration of the contracts involved and of the cost impact provisions prescribed by the acquisition agencies." 45 Fed. Reg. 8677 at 8678 (Feb. 8, 1980); ("[T]he essence of materiality criteria is to allow for the [exercise] of judgment." 42 Fed. Reg. 54254 (Oct. 5, 1977)) (CAS Board statements in promulgating what is now 48 C.F.R. § 9903.305) This discretion is considerable but it is subject to the required review by the contracting officer of the materiality criteria in § 9903.305 where appropriate ("In determining whether amounts of cost are material or immaterial, the following criteria *shall* be considered where appropriate" (emphasis added)); *see Raytheon Co., Space & Airborne Systems*, ASBCA No. 58068, 16-1 BCA ¶ 36,484 at 177,773.[25]

In this appeal, DACOs Hart and Olbrych have attested, and appellant does not dispute, that they considered all of the criteria in reaching their materiality determinations. Moreover, we have not found any evidence that the DACOs acted arbitrarily or capriciously or in bad faith or abused their discretion. (Findings 143, 149)

In sum, the DACOs acted within the parameters of the APA, and the government did not breach it, when the DACOs reviewed whether appellant's use of MTC as the cost of collaboration parts had a material impact upon the costs charged to government contracts.

Merits of Government's CAS 418 Claims

The government bears the burden to prove that appellant did not comply with CAS 418. *Sikorsky*, 773 F.3d at 1322.

[25] *Raytheon* identifies the abuse of discretion review standard as consideration of "(1) evidence of whether the government official acted with subjective bad faith; (2) whether the official had a reasonable, contract-related basis for her decision; (3) the amount of discretion given to the official; and (4) whether the official violated a statute or regulation." 16-1 BCA ¶ 36,484 at 177,773 (citing *Campbell Plastics Engineering & Mfg., Inc. v. Brownlee*, 389 F.3d 1243, 1250 (Fed. Cir. 2004)).

Appellant's Use of MTC as the Cost of Collaboration Parts
Does Not Comply with CAS 418

Appellant asserts that CAS 418(d) does not require that costs included in a material cost base for the allocation of indirect costs be "actual" costs. While it acknowledges that CAS 418-50(a)(2) provides that "[i]n accounting for direct costs a business unit shall use actual costs," it alleges that, because material overhead is not a direct cost, it need not be allocated by using actual costs.

The government counters that, like all allocation bases, Pratt's direct material base allocates indirect costs. However, under CAS 418-50(a)(2) ("In accounting for direct costs a business unit shall use actual costs"), the direct material cost in the base needs to be accounted for using actual costs. This has been DCAA's and the DACOs' position for many years (*see, e.g.*, the 192 audit report, finding 134, and the December 24, 2013 COFD, finding 149).

The government's interpretation is consistent with *Rumsfeld*, where the court stated that "under CAS 410, 418 and 420, in allocating G & A, B & P, and IR & D, Pratt was required to include a cost for collaboration parts in its allocation bases." *Rumsfeld*, 315 F.3d at 1377; *see also Rumsfeld* at 1366 ("Pratt allocated its G & A expenses to cost objectives using direct material cost as its allocation basis . . . Thus, a cost base calculated using direct material costs aggregated the 'costs' of all materials used in performing the project.")

We conclude that the government has the more reasonable interpretation of CAS 418-50(a)(2) and its related provisions and that appellant was required to use actual costs as the cost of its collaboration parts.

As defined in CAS 401-30(a)(2), "[a]ctual cost means an amount determined on the basis of cost incurred (as distinguished from forecasted cost)." MTC, in contrast to actual cost, [redacted] is "a theoretical value, a notional cost lever . . . it's never, say, the true cost" (finding 17). Appellant's representations in the predecessor litigation, its own documentation, and testimony by its witnesses establish that there can be no doubt that MTC is not an actual cost. (*See, e.g.*, findings 17-18, 20, 74-76, 89, 135, 157, 160)

Appellant's Use of MTC as the Cost of Collaboration Parts
Does Not Comply with *Rumsfeld*

Appellant disagrees with the Federal Circuit's *Rumsfeld* decision and, in this litigation, has disregarded the court's ruling with respect to the cost of collaboration parts. In *Rumsfeld*, which is binding upon the Board, the court determined that the price Pratt paid for collaborator parts, and their cost, was revenue share, as follows: Pratt "paid a

'price' for the parts. It became bound by the obligation *to pay the collaborators' share of revenue* just prior to its transfer of parts to a purchaser." *Rumsfeld*, 315 F.3d at 1371 (emphasis added); "the transactions constituted a sale, wherein title passed from the foreign collaborators to Pratt and Pratt became obligated to pay a price to the foreign collaborators *representing the revenue share*." *Id*. at 1372 *and see* n.13 (court treats revenue share attributable to a particular part as a material cost); "[i]n short, we find the terms 'cost' and 'material cost' as used in CAS to be clear and unambiguous, and *to include the revenue share payments made by Pratt for the parts under the collaboration agreements*." *Id*. (emphasis added); "[i]n summary, we hold that the CAS regulations define material costs in terms of items purchased for a price, and that the collaboration parts satisfy this definition" *id*. at 1377; and "we hold that Pratt purchased the parts from its foreign parts suppliers, and that *the revenue share payments* comprise costs for those parts." *Id*. at 1378 (emphasis added). Moreover, to the extent Pratt argues that MTC is a superior measure of the cost of parts because it is "consistent" and "stable" (app. br. at 79), this goes against *Rumsfeld's* holding that the part cost must be "measured as of the time it is used in production." *Rumsfeld*, 315 F.3d at 1372 n.13.

Thus, Pratt's use of the notional MTC as the cost of collaboration parts, rather than the revenue share payments specified by the court, does not comply with *Rumsfeld*.

Revenue Share Payments Do Not Include Payments for Items Other Than Parts

Rumsfeld quoted from the Board's 2001 decision that all of the collaboration agreements but one "provide[d] that the sharing of gross revenues from the sale of engines and parts will be '*in consideration of* the parts manufactured.'" *Rumsfeld*, 315 F.3d at 1371. In footnote 19 the court allowed Pratt to provide evidence on remand "to show that the revenue share payments included payments beyond that for the collaboration parts." *Id.* at 1377 n.19 (finding 32). The burden of proof was on Pratt. *Rumsfeld*, 315 F.3d at 1377 n.19.

Appellant urges that the word "comprise" in the court's holding that revenue share payments "comprise costs" for the parts should be read as open-ended, to mean "included but not limited to." The case appellant cites for this proposition, as it acknowledges, is in the specialized area of patent law (app. br. at 78, *citing CIAS Inc. v. Alliance Gaming Corp.*, 504 F.3d 1356 (Fed. Cir. 2007)), under different facts and law than apply here. We conclude that, here, the most reasonable interpretation in context is that "comprise(s)(d)" means "consists of." This is in harmony with the court's several other usages of the word in its decision, *i.e*., "[a]llowable indirect costs must be allocated according to a base comprised of direct costs" (*Rumsfeld*, 315 F.3d at 1363); "[t]he CAS comprise a set of rules" (*id*. at 1365); "[t]he Board instead found that the collaboration agreements comprised a form of 'collaborative partnering,'" (*id.* at 1368); and "GAAP comprises a hierarchy of different sources" (*id*. at 1374, n.17).

Dictionary definitions also support our interpretation. *See, e.g*., Oxford Advanced Learner's Dictionary (synonym for "comprise" is to "consist of somebody/something," "consist of"); Oxford Lexico ("comprise primarily means "consist of").

In sum, we have found (finding 187), and we affirm, that Pratt has not met its burden to prove that its revenue share payments to collaborators include payment by Pratt for any items other than parts (or for services integral to providing the parts).

Net Revenue Share, Rather Than Gross Revenue Share, is the Proper Measure of the Cost of Collaborator Parts

Contrary to the parties' various contentions, when the court in *Rumsfeld* held that revenue share payments were the cost of collaboration parts, it did not specify gross revenue share or net revenue share. However, in its holding, quoted above, and elsewhere in its decision, the court's focus was upon payments.

As DACO Morrow recognized in his December 2, 1996 COFD, prior to the instant litigation, "[t]he *net revenue share payment* represents a cost to P&W because *it is what P&W actually pays* to its collaborators for the parts it receives" (app. supp. R4, tab 85 at 4; *see also* finding 29) (emphasis added). The government also used net revenue share in its 2010 forward pricing audit, although, at the hearing, auditor Nardi claimed confusion and mistake (findings 129, 131). Appellant's expert, Ms. LeeVan, determined persuasively that Pratt pays net revenue share to collaborators (finding 175). The purchase price Pratt actually pays to collaborators is net of any discount or concession (finding 52, *see* finding 130). Pratt's representative, Ms. Lazinsk, testified credibly that collaborators are never paid gross revenue share (finding 56).

Thus, we determine that net revenue share, rather than gross revenue share, is the proper measure of the cost of collaborator parts.

DECISION

We grant appellant's appeal to the extent that we conclude that the portion of the government's CAS 418 claims covering the period from January 1, 2005 through June 5, 2006, is barred by waiver; the government's entire Drag credit claim is barred by accord and satisfaction; and net revenue share, rather than gross revenue share, is the proper measure of the cost of collaborator parts. Otherwise, we deny the appeal, conclude that appellant violated CAS 418 by using MTC rather than NRS, which had a material impact upon costs charged to overhead in government contracts, and we remand the appeal to the parties for resolution of quantum.

Dated: November 22, 2021

CHERYL L. SCOTT
Administrative Judge
Armed Services Board
of Contract Appeals

I concur

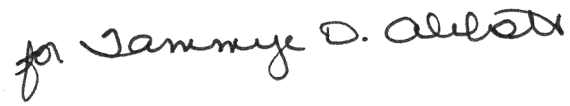
RICHARD SHACKLEFORD
Administrative Judge
Acting Chairman
Armed Services Board
of Contract Appeals

I concur

DAVID D'ALESSANDRIS
Administrative Judge
Acting Vice Chairman
Armed Services Board
of Contract Appeals

I certify that the foregoing is a true copy of the Opinion and Decision of the Armed Services Board of Contract Appeals in ASBCA No. 59222, Appeal of Pratt & Whitney, rendered in conformance with the Board's Charter.

Dated: November 23, 2021



PAULLA K. GATES-LEWIS
Recorder, Armed Services
Board of Contract Appeals