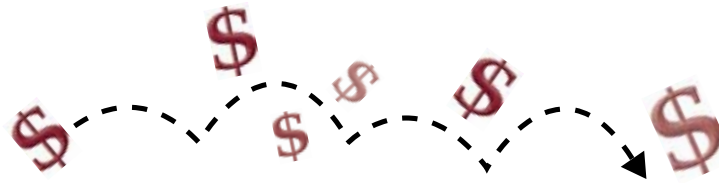


# Change Order Accounting:

Why Contracting Officers Should Require It;  
Why Contractors Should Do It Anyway



**Change order accounting** benefits both the contractor and the government. It reduces the costs the contractor would incur to substantiate its change order claim by contemporaneously documenting the contractor's increased costs. For the government, insisting on change order accounting requires the contractor to use its actual costs, rather than estimates of suspect reliability.

**By Jeffrey P. Hildebrant & Peter A. McDonald**

To almost anyone but an accountant, the topic of change order accounting might sound deceptively dull and arcane. However, the amount of money potentially at stake that depends on the existence of good change order accounting should be enough to spark the interest of even the most jaded contracting officer or contractor.

For contractors, implementing a system of change order accounting appropriate to the size of a change order claim is always a good idea. This is because the burden of proof to substantiate a claim always rests with the contractor. For contracting officers (COs), change order accounting should be required whenever permitted—without it, the government may be held liable for claims based on contractor estimates that are inherently less reliable than actual costs.

### What is Change Order Accounting?

Change order accounting refers to the accounting procedures that a contractor uses to segregate its costs to perform the work identified in a particular change order from the other costs it incurs to perform the contract. Change order accounting helps the parties determine the amount that the contract price should be adjusted (up or down) for changed work. To understand how best to implement change order accounting, one must first understand the basis for claims by the contractor for a contract price adjustment, known as a request for an equitable adjustment (REA).

### Equitable Adjustments Under the Changes Clause

Regardless of the type of contract, the most frequent type of claim made under a government contract is one arising under the applicable Changes clause, and this has long been the case. Notwithstanding its widespread occurrence, change orders are addressed in one of the shortest parts of the *Federal Acquisition Regulation (FAR)*, Part 43.

The *FAR* contains five different changes clauses for differing types of contracts.<sup>1</sup> All of these clauses essentially provide that the CO (1) is authorized to make certain types of changes within the general scope of the contract; and (2) will make an equitable adjustment to the contract price (and/or delivery schedule) if the change causes an increase or decrease in the cost of, or time required for, performance of the contract.<sup>2</sup> This clause is the basis for contractor claims to increase the contract price, and for government claims to decrease the price, whenever a change occurs. Under the clause, the contractor asserts its right to a claim by submitting a REA that justifies the price and/or schedule adjustment that it seeks. Good change order accounting can provide the data the contractor needs to substantiate its position.

There are two types of changes recognized by courts and boards: actual and constructive.

### Actual Change Orders

Actual changes occur by direction of the CO in accordance with the Changes clause, as previously stated. This is normally a two-step process. The first step is for the CO to issue a change order (usually via a *unilateral* modification). The change order specifically describes the change in work. The second step is the execution of a supplemental agreement. The supplemental agreement, which is a *bilateral* modifica-

tion to the contract, makes changes to the price and schedule.

### Constructive Changes

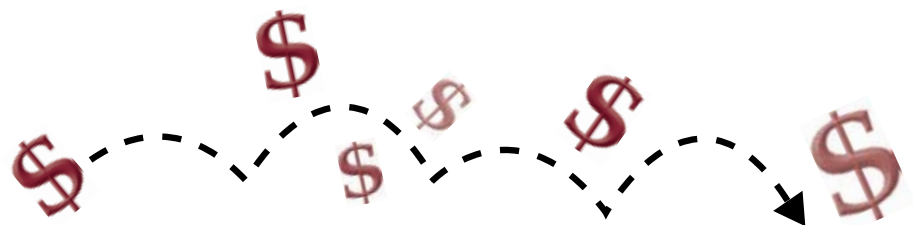
Under longstanding judicial precedent, constructive changes occur when work is performed beyond the contract requirements without a formal order, either due to an informal order or through the fault of the government.<sup>3</sup> For example, a constructive change may arise when a government inspector wrongfully rejects conforming goods, or where a government engineer provides defective site maps.

A contractor adversely affected by either an actual change or a constructive change should be able to rely on its accounting system for the information necessary to attain full recovery of its additional costs of performance.

### Implementing Change Order Accounting

As previously noted, the Changes clause requires an adjustment to the contract price if a change increases or decreases the cost to perform the work. With change order accounting, the task of determining the additional costs is largely one of extracting the data from the accounting system.

If the change order requires new work that was not contemplated in the original



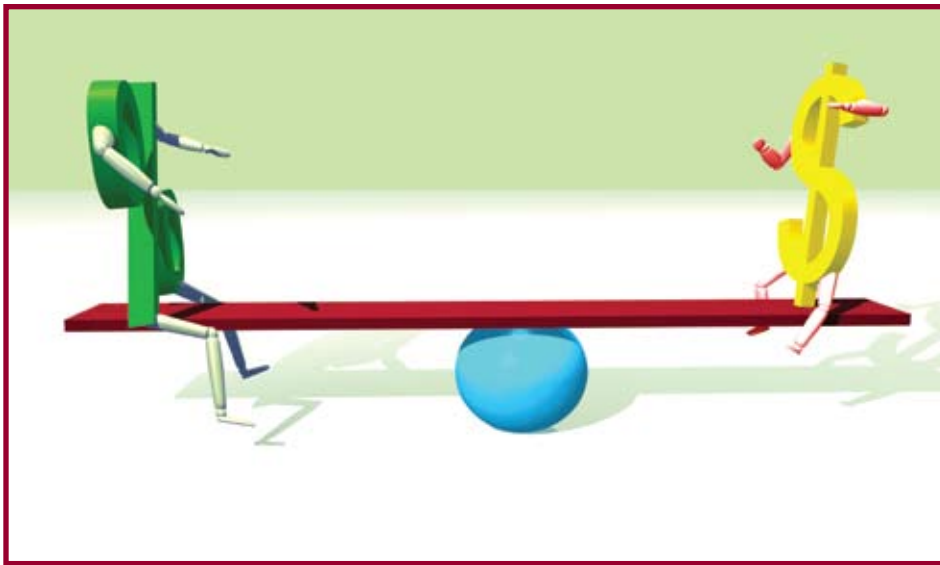
contract, then the contractor should set up specific accounts to record labor, purchases of materials, intracompany transfers, and other costs incurred to perform the new work. For example, suppose a contractor uses a job-costing system in which a NASA contract is coded “4117.” Employees working under that contract would charge their time to “4117,” personnel in the purchasing department would charge materials bought for that contract to “4117,” and so on. When a change order occurs, the affected employees would be instructed to still charge their time to “4117” when working on the contract, but to charge their time to “4117a” or some other unique number when working on the change. In like manner, the purchasing department would charge “4117” when buying items for the contract, but would charge “4117a” when getting additional materials for the change. These new costs, minus any costs that the contractor avoided due to the change, would form the basis for the contractor’s REA. If the change requires only the *deletion* of work, then new account numbers would not *necessarily* be required because no new costs are to be incurred due to the change. However, depending upon the magnitude of the deleted work, a contractor may want to use entirely new accounts to show the decrease in contract expenditures due to the change.

### The Unattractive Alternative to Change Order Accounting

A contractor that submits an REA for a substantial change without instituting change order accounting is at a severe disadvantage in two respects.

First, the contractor may be unable to ascertain the actual costs it incurred to perform the changed work. Without actual costs, the contractor may be unable to prove its claim. Courts generally prefer that contractors prove their claims using the actual cost method for the following compelling reason:

[The actual cost method] provides the court, or contracting officer, with documented underlying expenses, ensuring that the final



amount of the equitable adjustment will be just that—equitable—and not a windfall for either the government or the contractor.”<sup>44</sup>

Estimating actual costs may occasionally be used as an alternative. Such estimates may be based, for example, on contractor testimony as to the hours expended or on purchase orders for materials similar to those that were used. However, estimates are less credible than actual costs and are easily challenged.

An alternative is to use the total cost method, which simply calculates the difference between the contractor’s bid and its higher actual costs. It is easy to imagine that a contractor could have incurred at least some increased costs for reasons unrelated to the changed work. This could happen, for example, if its bid was too low

or other problems emerged that were not the government’s fault. For this reason, courts will reject a claim based on the total cost method, unless the contractor can prove: (1) the impracticability of proving its actual losses directly, (2) the reasonableness of its bid, (3) the reasonableness of its actual costs, and (4) lack of responsibility for the added costs.<sup>5</sup> Case law shows that proving these elements is very difficult and, accordingly, successful total cost method claims are rare.

The second disadvantage to developing claims without change order accounting is that isolating actual change order costs or developing credible estimates can be a difficult and costly process. Isolating change order costs after they have already been incurred can require, for example, a detailed review of payroll records, purchase

orders of materials, modifications of subcontractor agreements, project progress charts, and similar documents.

Usually, a detailed cost analysis is too complex or time consuming to perform in-house. However, even if the contractor’s staff is capable of developing the necessary data, the effort required to do so and resulting disruption to normal operations could exceed the cost that the contractor would have incurred to set up a relatively simple change order accounting procedure.

### Disaster Recovery and Records Reconstruction

Sometimes, contractors do not possess their actual cost data in whole or in part when it is needed because of a natural disaster, equipment malfunction, or procedural error.

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Fortunately, it is frequently possible for accountants to reconstruct lost data. Disaster recovery measures can be physical, such as retrieving data from a damaged hard drive. However, disaster recovery can also involve data reconstruction.

In general, data reconstruction refers to the methodologies undertaken by accountants to determine, with reasonable precision, what the lost numbers should have been. To illustrate, suppose a factory burns to the ground the day before payday, and all the payroll records are lost. Despite the fact that virtually none of the payroll records are available, accountants likely can reconstruct the entire payroll with a high degree of accuracy by referring, for example, to each employee's most recent federal and state tax withholding information. By a process of reverse engineering, the payroll amounts can then be reliably ascertained. Not surprisingly, there are many other instances where lost data may be similarly reconstructed by reference to collateral sources.

### Change Order Accounting Required by the Contracting Officer

In complex contracts, the contractor may be required under the Change Order Accounting clause to implement change order accounting for changes expected to exceed \$100,000. The presence of the clause affects the type of evidence that a court or board will accept in support of a contractor's claim. Case law indicates that if the clause is in the contract *and* the CO requires change order accounting, the contractor will be required to support its claim with actual costs—not with estimates or the total cost method. Conversely, if the CO could have included the clause, but did not (or did not require the contractor to implement change order accounting), then the contractor will not be required to support its claim with actual costs, provided the alternate basis for its claim is reasonable.

### FAR Clause

The CO is permitted to insert the Change Order Accounting clause, FAR §52.243-6, into a supply or research and development contract if the contract is of significant complexity and where numerous technical changes are anticipated, or into a construction contract whenever "appropriate."<sup>6</sup> The clause provides as follows:

The contracting officer may require change order accounting whenever the estimated cost of a change or series of related changes exceeds \$100,000. The contractor, for each change or series of related changes, shall maintain separate accounts, by job order or other suitable accounting procedure, of all incurred, segregable direct costs (less allocable credits) of work, both changed and not changed, allocable to the change. The contractor shall maintain such accounts until the parties agree to an equitable adjustment for the changes ordered by the contracting officer or the matter is conclusively disposed of in accordance with the Disputes clause.<sup>7</sup>

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Note that the CO “may” require change order accounting. This means that there is no duty to perform change order accounting due to the mere presence of the clause in the contract. Rather, the contract must contain the clause *and* the CO must specifically require change order accounting on a change or a series of changes expected to exceed \$100,000. There is no requirement for change order accounting on a change or series of changes less than \$100,000.

## What Happens if the Contractor Fails to Comply with the Clause?

Case law shows that a contractor who fails to comply with the clause regarding a particular change may forfeit its claimed price adjustment for lack of proof. For example, in *Phoenix Control Systems, Inc.*,<sup>8</sup> the contractor’s \$400,000 claim for differing site conditions (conditions the government agreed existed) was denied in significant part because the contractor failed to account for the actual costs incurred as a result of the changed condition, as required by the contract. Unfortunately, the contractor’s remaining evidence was considered unreliable. Similarly, in *Mergentime Corp. v. WMATA*,<sup>9</sup> the court rejected the plaintiff’s claim calculations in favor of the government’s lower estimate due, in part, to the plaintiff’s failure to account for the increased costs required by the change order accounting clause.

## What Happens if the Contracting Officer Could Have, But Failed to, Require Change Order Accounting?

The government’s failure to require change order accounting when it could have done so has been held to be sufficient cause to allow a contractor to support a price adjustment with estimates, rather than actual cost records.<sup>10</sup> This occurred, for example, in *Advanced Engineering & Planning Corporation, Inc.*,<sup>11</sup> where the board overruled the government’s objections that the contractor did not support its numerous claims with actual costs. The board remanded the claims to be calculated on

the basis of the contractor’s estimates, using rates approved by the Defense Contract Audit Agency. Similarly, in *United States v. Service Eng’g Co.*,<sup>12</sup> the court did not require the contractor to substantiate its claim using actual cost data based on the contractor’s “justifiable inability” to record such data. Under the circumstances, the court found, the costs for the changed work could not easily be segregated from the underlying contract costs. However, the court indicated that this inability would have been the contractor’s problem, not the government’s, if the CO had included the Change Order Accounting clause.

Note that including the Change Order Accounting clause in the contract is not enough to require the contractor to institute change order accounting. The CO must also direct the contractor to implement change order accounting on a particular change order. In *Bath Iron Works Corp.*,<sup>13</sup> the contract contained the clause, but the change modification failed to require the contractor to implement change order accounting for that particular change. Consequently, the government’s objections to the contractor’s failure to substantiate its claims with actual costs were rejected. The contractor was permitted to substantiate its claims with estimates that the board deemed to be reasonable.

In each of these cases, the actual cost method usually preferred by courts was not required because the government failed to require change order accounting.

## Conclusion

Change order accounting benefits both the contractor and the government. For the contractor, change order accounting reduces the costs the contractor would incur to substantiate its change order claim by contemporaneously documenting the contractor’s increased costs. For the government, insisting on change order accounting requires the contractor to use its actual costs, rather than estimates of suspect reliability. **CM**

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## ENDNOTES

1. FAR 52.243-1, Changes-Fixed Price (Supply; Ind. Del.; SAP); FAR 52.243-2, Changes-Cost Reimbursement (Supply; Service, Construct.); FAR 52.243-3, Changes-Time and Materials or Labor Hours (T&M; LH); FAR 52.243-4, Changes (Fixed price construct.; DDR); FAR 52.243-5, Changes and Change Conditions (Fixed price construct.; DDR); SAP: Simplified acquisition procedures, DDR: Dismantling, demolition, or removal of improvements. Under the uniform Contract Format, all Change clauses appear in Section 1.
2. Of course, if a change would cause the contractor to exceed the limits under a Limitation of Funds or Limitation of Costs clause, the contractor would have no obligation to continue performance beyond those limits.
3. See, e.g., *Len Co. & Assocs. v. United States*, 385 F.2d 438, 443 (1967).
4. *Propellex Corp. v. United States*, 342 F.3d 1335 (Fed. Cir. 2003), quoting *Dawco Construction, Inc. v. United States*, 930 F.2d 872, 882 (Federal Circular 1991), overruled in part on other grounds, *Reflectone, Inc. v. Dalton*, 60 F.3d 1572 (Federal Circular 1995) (en banc).
5. *Propellex Corp., id.* (citing *Servidone Constr. Corp. v. United States*, 931 F.2d 860, 861 (Federal Circular 1991)).
6. FAR §43.205(f).
7. FAR §52.243-6 (emphasis added).
8. IBCA No. 2844, 96-1 BCA ¶ 28,128.
9. Civ. Action No. 89-1055, 1997 U.S. Dist. LEXIS 23408 (D.D.C. 1997).
10. See *Advanced Engineering & Planning Corporation, Inc.*, ASBCA Nos. 53366, 54044, 2005-1 BCA ¶ 32,806, citing *Service Engineering Co.*, ASBCA No. 40274, 93-1 BCA P 25,520, recons. granted in part on other grounds, 93-2 BCA P 25,885.
11. IBCA, see note 8.
12. No. C-93-2591-VRW, No. C-94-0271-VRW, 1994 U.S. Dist. LEXIS 13596 (N.D. Cal. 1994).
13. ASBCA Nos. 44617, 45232, 97-2 BCA ¶ 29,073.