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VIA U.P.S. OVERNIGHT DELIVERY

Ms. Deidre A. Lee
Director, Defense Procurement
Office of the Under Secretary of Defense
for Acquisition, Technology and Logistics
U.S. Department of Defense
Washington, D.C. 20301-3000

**Re: January 17, 2002 Guidance on CAS --
Changes in Cost Accounting Practice**

Dear Ms. Lee:

On behalf of the Section of Public Contract Law of the American Bar Association (“the Section”), I am submitting comments on the above-referenced matter. The Section consists of attorneys and associated professionals in private practice, industry, and Government service. The Section’s governing Council and substantive committees contain members representing these three segments to ensure that all points of view are considered. In this manner, the Section seeks to improve the process of public contracting for needed supplies, services, and public works.

The Section is authorized to submit comments on acquisition regulations under special authority granted by the Association’s Board of Governors. The views expressed herein have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, therefore, should not be construed as representing the policy of the American Bar Association.

The January 17, 2002 guidance, issued by the Office of the Director of Defense Procurement (“DDP”), is aimed at assisting contracting officers in determining whether there has been a change in cost allocation practice in connection with organizational changes. The Section’s concerns with the guidance fall broadly into two areas. First, the DDP guidance conflicts with existing Cost Accounting Standards (“CAS”) Board regulations and with current case law on the subject of what constitutes a change in accounting practice. It does so by: (1) equating the transfer of a function (such as computer support services, or payroll processing) from one segment to another segment with a change in cost allocation practice; and (2) equating mere changes in the composition of indirect cost pools or allocation bases resulting from organizational changes with changes in cost allocation practices. Both of these propositions are central in the DDP guidance, yet both are contrary to CAS Board regulations and to the court’s holding in *Perry v. Martin Marietta Corp.*, 47 F.3d 1134 (Fed. Cir. 1995).

Second, we are concerned that the Department of Defense (“DoD”) has issued the guidance without affording any opportunity for notice or comment by the public. While we recognize that the guidance was issued as procurement policy that is not binding on contractors, 41 U.S.C. § 418b requires that procurement policies, regulations, or procedures that will have a significant effect beyond the issuing agency’s internal operating procedures or significant cost or administrative impact on contractors or offerors be issued for public comment. This guidance meets those parameters, since it greatly increases the number of events considered to be cost accounting practice changes giving rise to potential liability for contract cost and price adjustments.

We address each of these areas in turn.

I. The January 17, 2002 DDP Guidance Conflicts With Existing CAS Board Guidance And Case Law On The Subject Of Cost Accounting Practice Changes.

The January 17, 2002 DDP guidance states that its focus is on cost accounting practice changes related to cost allocations that occur in conjunction with organizational changes. It correctly notes that organizational changes by themselves are not cost accounting practice changes, and that contracting officers should focus on whether accounting methods or techniques have changed as part of the organizational change. As the guidance recognizes, CAS Board regulations include the following examples of cost accounting practices involving allocation of cost to cost objectives:

- accounting methods or techniques used to accumulate cost;

- accounting methods or techniques used to determine whether a cost is to be directly or indirectly allocated;
- accounting methods or techniques used to determine the composition of cost pools; and
- accounting methods or techniques used to determine the selection and composition of the appropriate allocation base

48 C.F.R. § 9903.302-1(c). The guidance also notes that: (1) the initial adoption of a cost accounting practice for the first time a cost is incurred or a function is created is not a change in cost accounting practice, nor is the partial or total elimination of a cost; (2) the transfer of contract work from one segment to another, *per se*, is neither a change in cost accounting practice nor a CAS 401 noncompliance; and (3) when there is a change in cost accounting practice, only “affected” CAS-covered contracts are subject to price or cost adjustment.

Focusing on the area of cost allocation practices, the guidance at the outset appears to distinguish between a “cost allocation practice” and a “cost accumulation practice.” The latter is described as “the collection of cost data for the functions and activities in specified cost pools and activities comprising the allocation bases.” *Cost accumulation* practices, says the guidance, generally change when there is a change in the composition of the cost pool or allocation base. Nevertheless, to determine whether there has been a change in *cost allocation* practice, the guidance exhorts the Administrative Contracting Officer (“ACO”) and auditor to focus on whether there has been a change in the method or technique for:

- (1) determining whether a cost is directly or indirectly allocated,
- (2) determining the composition of the cost pools,
- (3) determining the selection of the allocation base, or
- (4) determining the composition of the allocation base.

The language in this section of the guidance is not clear and is subject to more than one interpretation. On the one hand, if the guidance means to say that “cost accumulation practices” change when the composition of the indirect cost pool or the allocation base changes, but that “cost allocation practices” do not change unless there has been a change in an accounting method or technique, the Section would not object to this part of the guidance but would question the utility of introducing the term “cost accumulation practice.”

If the guidance, on the other hand, means to suggest that cost accumulation practices as defined in the guidance are equivalent to or are a subset of cost allocation practices, the guidance is erroneous. A cost allocation practice does not change merely because the composition of the pool or base changes. There must be a change in the *method* or *technique* used to determine the composition of the pool or base. We fear the latter interpretation is what is meant, because it is consistent with the illustrations the guidance goes on to provide.

A. Determining Whether a Cost Is Directly or Indirectly Allocated.

The first difficulty in the DDP guidance appears in this section. The guidance states at p. 3 that a change in direct vs. indirect allocation can occur (1) within a segment, (2) within a home office, (3) between two or more segments, (4) between two or more home offices, or (5) between a segment and a home office.

The guidance cites the following example: Segment S performs its own computer services function. Segment T performs computer services functions for itself and Segment U, and allocates the costs indirectly between the two. The computer services function at Segment S is transferred to Segment T and thereafter indirectly allocated to all three segments. The guidance calls this a change in cost allocation method for Segment S because the costs were directly identified at Segment S prior to the transfer but were indirectly allocated to Segment S after the transfer. There has been no change in cost allocation practice for Segments T and U because computer service costs were indirectly allocated both before and after the transfer.

The problem is that Segment S has not changed any of its accounting methods or techniques. What Segment S has done is to transfer a function to another segment. *That* is an organizational change, pure and simple. Whatever cost allocation method it used to allocate computer service costs to cost objectives, it is presumably still using. The key issue is the method or technique used to allocate cost *to cost objectives*, as set forth in 48 C.F.R. § 99030.302-1. The change identified by the guidance is not a change in the accounting method or technique used by the segment for allocation of cost to cost objectives, and therefore is not a change in cost accounting practice.

Contributing to the disconnect between this example and the CAS Board regulations on the subject is the assertion at the beginning of the section that a change in direct vs. indirect allocation may take place *between* segments, *between* home offices, or *between* a segment and a home office. Expanding the reach of the rule in this way

would mean that any organizational change involving the transfer of a function between segments, between home offices, or between a segment and a home office would be treated under this guidance as a change in cost allocation practice *even though none of the segments or home offices involved had changed its practices for allocation of cost to cost objectives.*

Another example given in this section is the transfer of a payroll function from two segments to the home office. The guidance states that this is a change in cost allocation practice for both segments if the home office indirectly allocates the cost of the payroll function to the segments, but not a change in cost accounting practice if the home office directly identifies the cost of the function to the segments. Nevertheless, the example fails to identify any change in the accounting methods or techniques used by either segment for allocation of cost to cost objectives. Instead, the guidance appears to confuse the cost accounting practice used by the home office to allocate costs to segments under CAS 403 with the cost accounting practice used by the segment to allocate costs to cost objectives. In this example, notwithstanding the guidance, there is no change in the segments' cost accounting practices; although there may have been a change in home office cost allocation practice, the guidance does not address this at all.

B. Determining the Composition of Cost Pools.

The guidance states that “[a] change to a method or technique used to determine the composition of cost pools occurs when a contractor changes the functions or activities that compose [sic] the indirect cost pool.” For instance, when a contractor combines two or more indirect cost pools, “there is a change in pool composition for the cost objectives of the previously separate pool(s) if the functions or activities of the previously separate pools are not generally the same as the functions and activities of the new combined pool.” The guidance also finds a change in cost accounting practice where a pool is divided into two or more pools, if the functions or activities in the new pools are not “generally the same” as those in the original pool. Other than the examples, no guidance is offered on how to determine whether the functions are “generally the same.” Finally, the guidance states that the transfer of a function from one pool to another is a “change in pool composition” for the transferring pool if it does *not* receive back from the receiving pool an allocated cost of the transferred function. Similarly, the transfer of a function is a “change in pool composition” for the receiving pool if it did not, prior to the transfer, contain that function.

As an example of a change in pool composition resulting from the combination of two pools, the guidance cites Company 1's acquisition of Company 2, which becomes new Segment B. Segment B has a fabrication cost pool containing the functions of fabrication supervision and tool calibration. This pool is combined with the assembly overhead pool of Segment A of Company 1, which contains the functions of assembly supervision, materials inspection, and machine maintenance. The combination presumably resulted from the merger of Segments A and B, since segments ordinarily do not share overhead cost pools. The guidance, without identifying any change in either Segment A's or Segment B's method or technique for determining the composition of cost pools, declares this circumstance to be a change in pool composition that will be treated as a change in cost accounting practice. A similar example is given to illustrate the division of a cost pool.

With respect to transfer of a function from one indirect cost pool to another, the guidance applies whether the transfer takes place within a segment, between segments, within a home office, between home offices, or between a home office and a segment. The examples that are given are not particularly helpful because they give no reasons for the transfer of the function and, thus, it is impossible to know whether the function transfer was part of an organizational change or even whether it was necessary to maintain the homogeneity of cost pools required by CAS 418 (and by CAS 403 for home office costs). After an organizational change, transfers may be necessary either to maintain pool homogeneity or to maintain the appropriate beneficial or causal relationship between cost and cost objective. *Martin Marietta Corp.*, 47 F.3d at 1137 (contractors' accounting practices for allocation of indirect costs follow the "beneficial or causal relationship" test under CAS 418).

The guidance -- by equating mere changes in pool composition to cost accounting practice changes -- is directly contrary to the *Martin Marietta* decision, to the regulations of the CAS Board at 48 C.F.R. § 9903.302, and to the CAS Board's explanation of those regulations in Preamble J. In *Martin Marietta*, the Court of Appeals for the Federal Circuit expressly rejected the Government's argument that changes to the size and composition of indirect cost pools and allocation bases that are purely the result of organizational changes constituted changes to cost accounting practices. 47 F.3d at 1138-39.

C. Determining the Selection of the Allocation Base.

The guidance states that selection of the allocation base refers to the allocation base measure of the beneficial or causal relationship between the costs in an indirect cost pool and the cost objectives to which the costs are allocated. Allocation base measures include direct labor dollars, direct labor hours, direct material costs, total cost input, etc. If a contractor changes its base for allocating engineering overhead costs from direct labor dollars to direct labor hours, that is a change in cost accounting practice used to determine the selection of an allocation base.

The Section believes this part of the guidance to be consistent with existing CAS Board guidance and case law.

D. Determining the Composition of the Allocation Base.

The DDP guidance is erroneous because it equates any change in the composition of the base to a change in cost accounting practice. Under the guidance, all changes in the allocation base, including those that result solely from organizational changes, would be deemed cost accounting practice changes, contrary to the CAS Board regulations and governing case law. The guidance states that a change in the composition of the allocation base occurs when there is:

- (a) a change in the elements of the allocation base, or
- (b) a change in the activities that are included in the base.

According to the guidance, “elements” of an allocation base are the components of the allocation base measure (*e.g.*, direct labor dollars only, or direct labor dollars plus overtime premium or fringe benefits). The “activities” included in the base are those activities (such as engineering, fabrication, or machining) that are related in some way to the activities or functions in the indirect cost pool. The guidance cites as authority the CAS Board’s statement in Preamble J that:

For allocation purposes the Board has concluded that the level of detail should include not only the types of base, *e.g.*, direct labor, but also the composition of that base, *e.g.*, the elements of labor costs comprising the base.

Consistent with this statement, the Board selected an illustration of a change in cost accounting practice resulting from the merger of two segments. Before the merger, Segment A allocated manufacturing overhead costs on a base of direct labor hours, while Segment B used a base of direct labor dollars. After the merger, the combined manufacturing overhead pool is allocated using a base of direct labor dollars. The change from direct labor hours to direct labor dollars is a change in the elements of costs comprising the base, which constitutes a change in cost accounting practice. 48 C.F.R. § 9903.302-3(c)(3).

In contrast to the existing CAS Board guidance in Preamble J and the cited illustration, the DDP guidance creates new policy (and a new level of complexity) by introducing the proposition that a change in the composition of the allocation base occurs when there is a change in the “activities” that are included in the base. Current CAS Board regulations address only the type of base (*e.g.*, direct labor) and composition of the base (*e.g.*, direct labor dollars plus fringe benefits). Neither the quoted language from Preamble J on which the guidance relies, nor the illustration at 48 C.F.R. § 9903.302-3(c)(3), support extending the level of detail beyond cost elements to “activities.”

E. Additional Guidance.

The DDP guidance concludes with additional discussion of: (1) transfer of functions; (2) transfer of contract work; and (3) affected CAS-covered contracts.

First, the guidance states that the transfer of a function between segments, between home offices, or between a segment and a home office does not constitute either an elimination of the function (for the transferring unit) or the creation of a function for the receiving unit. Neither does the merger of two or more segments or home offices constitute either the creation or elimination of a function. The purpose of this statement is apparently to support the view previously expressed in the guidance that a change in accounting practice occurs when a function is transferred either between indirect cost pools or from a business unit where it is directly identified to one that allocates the function indirectly. For the reasons stated above, we believe this view to be erroneous.

Second, the guidance makes clear DDP’s view that the transfer of contract work from one segment to another is neither a change in cost accounting practice nor a CAS 401 noncompliance, despite the fact that the contractor will incur costs according to the practices of the transferee segment rather than those of the transferor segment. This is important because it emphasizes that the issue is whether the accounting

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practices of either segment have changed, not whether the contract has experienced a change. The Section agrees with this part of the guidance.

Third, the guidance states that adjustments in the event of a cost accounting practice change will be made only to those CAS-covered contracts affected by the change. The example given is the merger of two indirect cost pools that were “generally the same” but used different allocation bases. Pool A was allocated over direct labor dollars, while Pool B was allocated over direct labor hours. After the merger, the combined pool is allocated over a base of direct labor dollars. According to the guidance, only those contracts formerly included in the allocation base for Pool B are affected by the cost accounting practice change, and only those contracts are subject to price or cost adjustments. The Section questions this portion of the guidance because all contracts receiving indirect cost allocations are “affected” if there is a cost impact resulting from a cost accounting practice change. The choice of which contracts to adjust should be a matter of contract administration.

II. DoD's Authority To Issue The Guidance.

The DDP has the authority to issue guidance on acquisition policy as part of its responsibility to provide "management direction of the procurement system of the executive agency," which includes implementation of the agency's unique procurement policies, regulations, and standards.¹ It is, however, the Cost Accounting Standards Board that possesses *exclusive* authority "to make, promulgate, amend and rescind cost accounting standards" *and to interpret those standards.*² *Boeing North American v. Roche*, __ Fed. Cir. __, 2002 U.S. App. LEXIS 15284 (July 29, 2002). This exclusivity was granted to the CAS Board as part of its reauthorization in the Office of Federal Procurement Policy Act Amendments of 1988 ("the "OFPP Act Amendments")³ and ensures that executive agencies do not issue regulations or guidance inconsistent with those promulgated by the CAS Board.⁴ To allow otherwise would impair the CAS Board's charge to "achieve uniformity and consistency" in CAS.⁵

Thus, the OFPP Act limits DDP's general authority to issue procurement guidance in the area of Cost Accounting Standards. We do not believe that DDP has the authority to issue guidance that conflicts with existing CAS Board regulations on a subject within the exclusive authority of the CAS Board.

Second, when an agency seeks to issue a policy, regulation, procedure, or form in the area of federal procurement, it *must* first subject the proposal to public comment if the issuance will have: (1) a significant effect beyond the internal operating procedures of the agency; or (2) a significant cost or administrative impact on contractors or offerors.⁶ As discussed above, the DDP guidance is contrary to governing case law and existing CAS Board guidance on the subject of cost accounting practice changes. It aggressively expands the definition of cost accounting change to

¹ 41 U.S.C. § 414(3) (imposing this responsibility on senior procurement executives -- for DoD, this is the Undersecretary for Acquisition and Technology to whom the DDP reports).

² 41 U.S.C. § 422(f)(1).

³ Pub. L. No. 100-679, §5a, 102 Stat. 4058, 4060 (1988).

⁴ 41 U.S.C. §§ 422(j)(3), (4).

⁵ 41 U.S.C. § 422(f)(1).

⁶ 41 U.S.C. § 418b(a).

encompass transfers of functions and changes in the composition of cost pools that are the result of organizational changes, thereby greatly expanding the universe of circumstances giving rise to potential liability for, and the attendant obligation to compute, the cost impact of such “changes.” There can be no doubt that the guidance will, if followed by DoD auditors and contracting officers, have significant cost and administrative impact on contractors and significant effect beyond the “internal operating procedures” of the agency. Therefore, a court likely would find the guidance invalid due to DDP’s failure to follow notice and comment requirements.⁷

Finally, the OFPP Act gives the OFPP Administrator express authority to take action to enforce the CAS Board’s exclusive authority over the Cost Accounting Standards. If the Administrator determines that an executive agency’s regulation or proposed regulation is inconsistent with CAS, the Administrator may deny promulgation of or rescind the regulation.⁸ Even if the Administrator chooses not to invoke this authority, an agency regulation inconsistent with CAS may not apply to costs subject to CAS.⁹

Conclusion

In conclusion, we recommend that the guidance be withdrawn. It is inconsistent with current CAS Board regulations and case law, and it suffers from serious questions regarding its validity. We believe that the guidance will spawn litigation and that it will not ultimately survive such litigation. Withdrawal would avoid unnecessary expenditure of resources by both the Government and its contractors. In the alternative, the Section would be happy to work with your office to revise the guidance to be more consistent with CAS.

⁷ 41 U.S.C. § 418b.

⁸ 41 U.S.C. § 422(j)(3). Invocation of this authority requires concurrence by the Director of OMB and consultation with the head of the agency concerned. 41 U.S.C. § 405(f).

⁹ 41 U.S.C. § 422(j)(4).

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The Section appreciates the opportunity to provide these comments and is available to provide additional information or assistance as you may require.

Sincerely,

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Chair, Section of Public Contract Law

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