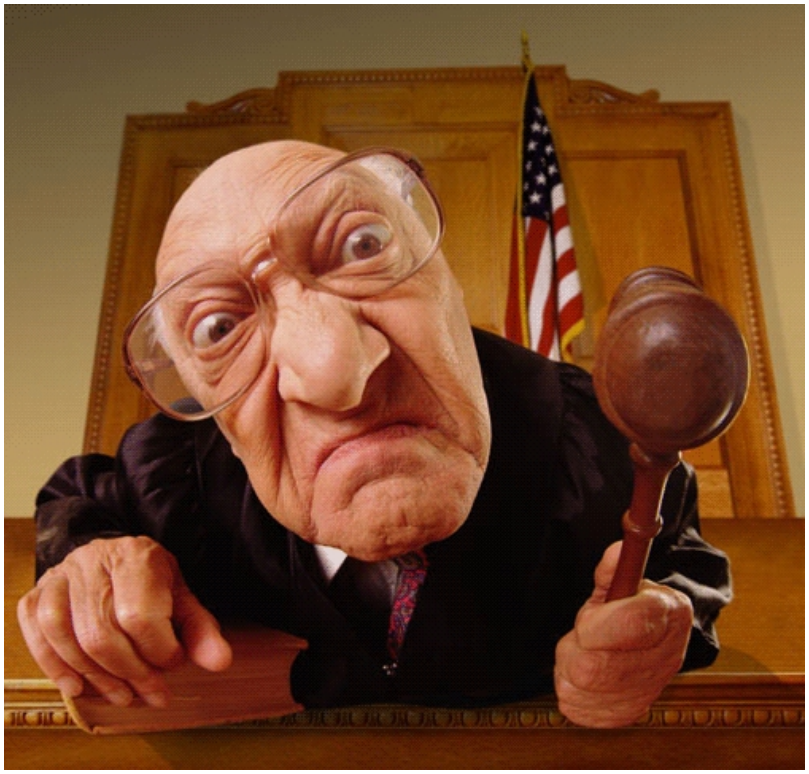

Long-time reader, supporter, and friend "Black Hawk Dawn" asked us to pontificate on the question "what is a 'cost' for Government contract cost accounting purposes?" She didn't know it, but that innocent question pushed one of our buttons and brought up unpleasant memories. Come with us down memory lane ….

Accept for a moment that the FAR does not define the term "cost". It defines "total cost" but elides any description of what is that nebulous term "cost" that is somehow made up "direct" and "indirect" expenses. And what about "cost of money" (aka Facilities Capital Cost of Money) which is an "imputed cost" for government contract cost accounting purposes? Is an imputed cost the same as a direct/indirect expense? How do we know?

Costs, or expenses, are "incurred" but they are also "recorded" on the contractor's books and records. What about costs that have yet to be incurred, but which have been recorded (e.g., accruals). Are they still costs for government contract cost accounting purposes?

The Cost Accounting Standards (CAS) regulations are of no help either. Though there is much to be found regarding the measurement, assignment, and allocation of costs, the CAS regulations actually don't ever define that term.

So now we have recorded costs, incurred costs, and imputed costs-but we are still no nearer to understanding what we mean by the term "cost". If the FAR and CAS won't help us to understand, where should we look?

Fortunately (or unfortunately, as the case may be) we have a couple of legal decisions that have answered that question for us. The decisions concern the Pratt & Whitney division of the United Technologies Corporation (UTC).

UTC had entered into several "collaboration agreements" with its suppliers (many of them foreign) in support of its commercial programs. Those agreements specified that UTC would not actually pay for the supplier parts; instead, UTC would give the individual suppliers contractually-specified percentages of total revenue generated by the program(s) they were supporting. In other words, UTC's "cost" for the supplier parts was zero, because it simply reduced sales it would otherwise have recorded and issued the suppliers a check for that same amount.

If UTC's treatment seems weird or strange, remember that many industrial companies were innovating at the time by making similar agreements with their suppliers. For instance, automakers developed the concept of paying tire suppliers not when an invoice was submitted and matched with a Purchase Order and Receiving document, but instead based on the number of cars that left the factory. Tire suppliers never had to submit an invoice; instead, every time a car left the factory, the automaker would assume it had a full complement of four (or five) tires, and pay the tire supplier accordingly. Naturally, innovations of this type reduced transaction costs: Suppliers never had to submit invoices, the automakers significantly streamlined their Accounts Payable processes, and the lag between invoice submittal and receipt of payment was dramatically shortened. It was a win/win for the automotive industry and UTC was looking to create similar win/win situations in the aerospace industry.

But UTC/Pratt & Whitney had both governmental and commercial programs. Use of collaboration agreements on the commercial programs meant that those programs recorded significantly less costs than did UTC's similar governmental programs (which did not use collaboration agreements). That was no big deal, except UTC-like almost all government contractors-allocated most of its indirect costs on the basis of program direct costs. Since the commercial programs used collaboration agreement accounting, they absorbed a lower share of indirect costs than they would have, had UTC used "traditional" supplier agreement accounting that recorded costs associated with supplier-provided materials (and which would

have included supplier profit as well).

The government didn't like the situation. It argued that its programs were paying too much for allocated indirect expenses because the commercial programs didn't record all their costs. The government argued that UTC's revenue-sharing payments to its suppliers should be treated as direct "costs" for purposes of allocating UTC's indirect costs and for purposes of calculating governmental indirect cost rates. A Contracting Officer's Final Decision (COFD) was issued, alleging that UTC was in noncompliance with CAS 410, 418, and 420 because UTC excluded the value of the collaboration parts from the cost input base it used to allocate (and calculate) indirect costs. UTC appealed that COFD **to the ASBCA** .

For its part, UTC argued that costs were costs, and that contra-revenue transactions were not costs as that term was generally understood. Since costs had to be "incurred" and/or "recorded" the revenue shares paid to collaboration suppliers were not costs. UTC's indirect cost allocations were not distorted because they were allocated on cost input bases that included all costs that UTC actually incurred.

Thus, the stage was set for an argument over the definition of "cost".

Both parties agreed that the term "cost" could not be found in the cost accounting regulations that govern contractors. The government argued that since CAS did not define "cost" then the GAAP definition must be used, and since the collaboration suppliers were subcontractors, then UTC should have recorded appropriate costs for purposes of calculating its cost input bases.

Interestingly, UTC also agreed that the parties must turn to GAAP to define "cost". But the two parties disagreed over which GAAP promulgation should control. (As a side note, we've often wondered why the first two words of the acronym "GAAP" are "Generally Accepted" because no two accountants seem to agree on any aspect of GAAP. But we digress.) Each side presented its own experts in an attempt to persuade Judge Park-Conroy which part of GAAP should be used to define "cost" and which part of GAAP should be used to evaluate whether the collaboration agreements generated costs that should be considered for government contract cost accounting purposes.

The case became a battle of the accounting experts.

On the government's side, Mr. Thomas O'Donnell (DCAA) testified on CAS and government contract cost accounting, and Mr. Staley Siegel (Professor, New York University Law School) testified on GAAP, audit standards, accounting practice and theory, business organizations, and finance. UTC called four experts: Dr. David Teece testified on organizational economics and industrial organizations; Mr. Nelson Shapiro (former Member of the CAS Board) testified on CAS and GAAP, Mr. William Keevan (Partner, Arthur Andersen) testified on CAS, GAAP, and cost accounting; and Dr. Charles Horngren testified on GAAP, cost accounting, and management accounting.

(We note with sadness that Darrell Oyer reported that Nelson Shapiro passed away last month, in March, 2014.)

After reciting the experts' opinions and positions, Judge Park-Conroy concluded that the collaboration agreement suppliers were not subcontractors and that UTC's share of program revenues were not "costs" for purposes of complying with CAS and GAAP. For example, she wrote-

The Government relies upon FASB Statement of Financial Accounting Concepts No. 6 for its definition of cost (an economic sacrifice to obtain goods and services) to support the assertion that Pratt incurs a cost for parts when it distributes program revenue share payments. As Mr. O'Donnell testified, this is the same definition of cost used in Riverside Research Institute, 860 F.2d at 422. Pratt responds, and we agree, that payment of a collaborator's program revenue share is not an economic sacrifice because Pratt has no right to retain that share. Rather, consistent with our discussion above, the payments are more like a 'pass through' because Pratt collects the sale price from the customers and distributes net program revenue share payments to the collaborators according to the terms of their agreements. Pratt does not treat the collaboration parts as a cost either when it records a sale or when it records the collection and distribution of the sale revenue.

Based on the foregoing, Judge Park-Conroy decided as follows-

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 under CAS 418.50(d)(2) or its G&A and IR&D/B&P total cost input bases under CAS 410.50(d)(1) and CAS 420.50(f)(2). Pratt's accounting for collaboration parts complies with these CAS requirements.

At the time, we thought this to be a ground-breaking decision, because it acknowledged that the FAR did not prescribe the universe of transactions between those acquiring goods and services, and those providing them. The decision recognized that there were other-perhaps more innovative-types of contracts, subcontracts, and supplier agreements than were specified in FAR Part 16. The decision implicitly rested on the notion that private industry was innovating faster than the Federal government, and it was incumbent on the Federal government to catch up, at least in its regulatory coverage if nothing else.

And yet our joy at the decision was short-lived. The Government appealed to the Federal Circuit, and Judge Dyk issued a **reversal and Government victory** that was every bit as ground-breaking as Judge Park-Conroy's decision had been … but for the wrong reasons.

Now remember, dear readers, that we here at Apogee Consulting, Inc. are not attorneys and our legal analyses are those of laypersons. As such you must give our opinions little weight and consult your own learned counsel before proceeding based on the opinions you read herein. But our opinions are bolstered by others' views, including a **restrained yet pointed critique** by a well-respected public contract law attorney.

Judge Dyk started by rejecting the views of *all* of the experts that testified in the ASBCA case, writing-

The issue in this case is whether CAS required Pratt [UTC] to include a 'cost' for collaboration parts in its allocation bases used to allocate overhead. Resolution of this question requires us to interpret CAS. Contrary to the Board's approach, the central issue we confront - the interpretation of CAS - is an issue of law, not an issue of fact. . .The views of the self-proclaimed CAS experts, including professors of economics and accounting, a former employee of the CAS Board, and a government contracts accounting consultant, as to the proper interpretation of those regulations is simply irrelevant to our interpretive task; such evidence should not be received, much less considered, by the Board on the interpretive issue. That interpretive issue is to be approached like other legal issues - based on briefing and

argument by the affected parties.

Having rejected all evidence and testimony proffered to the trial judge regarding what might be meant by the term "cost" and whether UTC had, in fact, incurred a "cost" when it made a revenue-sharing payment to its collaboration suppliers, Judge Dyk then turned "to standard dictionary definitions and other pertinent regulations."

Judge Dyk's journey into dictionary definitions and other pertinent regulations is worth quoting at some length, if only to show readers an excellent example of tautology and circular reasoning, seasoned with deliberate ignorance regarding the trial court's findings. He wrote-

Given that 'material cost' is involved, the pertinent definition of 'cost' is 'an item of outlay incurred in the operation of a business enterprise (as for the purchase of raw materials, labor, services, supplies) including depreciation and amortization of capital assets.' Webster's Third New International Dictionary 515 (1968) ('Webster's') (emphasis added). There is no suggestion that the accounting source references use a materially different definition. [*Ed. Note: Correct, because Judge Dyk rejected all the suggestions by all the experts he was ignoring.*
] Indeed, the parties before the Board agreed on a definition of 'cost' as 'the sacrifice incurred in economic activities that which is given up or forgone to consume, to save, to exchange, to produce.' … We have indeed approved the use of a similar definition of 'cost' under earlier procurement regulations, stating that "cost' is equated with the amount a contractor forgoes or gives up, i.e., its economic sacrifice, to obtain goods or services.' *Riverside Research Inst. v. United States, 860 F.2d 420, 422*
(Fed.Cir.1988) (citing FASB Concept Statement No. 3, which provides '[c]ost is the sacrifice incurred in economic activities-that which is given up or foregone to consume, to save, to exchange, to produce, etc.').

In addition to dictionary definitions, clarity in the term 'cost' as used in CAS may also be provided in related regulations, such as FAR. FAR provides the general regulatory scheme for contracts with the federal government and '[the] policies and procedures for applying the Cost Accounting Standards Board (CASB) rules and regulations to negotiated contracts and subcontracts.' 48 C.F.R. § 30.000 (2001); see also Lane K. Anderson, Accounting for Government Contracts Cost Accounting Standards § 1.06 (2002). Thus, the usage of the word 'cost' in FAR is instructive of its usage in CAS. [*Ed. Note: Here Judge Dyk was ignoring the part of the CAS statute that exclusively reserves the right of the CAS Board to interpret its own regulations.*] The definitions section of FAR defines 'material costs' as 'includ[ing] the costs of such items as raw materials, parts,

sub-assemblies, components, and manufacturing supplies, whether purchased or manufactured by the contractor, and may include such collateral items as inbound transportation and intransit insurance.' 48 C.F.R. § 31.205-26 (2001) (emphasis added). [*Ed. Note: Here Judge Dyk was using the definition found in a individual FAR Cost Principle - and not found the definitions section of the FAR - to interpret CAS. In other words, he was using an allowability prescription to interpret a cost allocation prescription, which is interesting, to say the least.*]

Thus, both standard dictionaries and FAR define 'cost' or 'material cost' to include the outlay for materials 'purchased.' The standard dictionaries do not define 'purchase' with any precision. Nor does the FAR or CAS itself. [*Ed. Note: Not that those omissions will stop Judge Dyk from his quest to create a definition.*] However, in addition to dictionaries, this court has recognized that the Uniform Commercial Code (U.C.C.) is useful for determining 'the ordinary commercial meaning of terms.' … In order to determine whether there has been a purchase, we look to see whether there has been a 'sale' by the parts suppliers to Pratt. The U.C.C. defines 'sale' as 'the passing of title from the seller to the buyer for a price.' … The point in time when title passes may be defined by explicit agreement of the parties. … Contrary to the Board's finding that 'Pratt does not take title to the collaboration parts,' … Pratt's witness confirmed that '[t]itle, as far as Pratt & Whitney is concerned, in order to be able to convey title to the engine when it sells it to the customer, that is an instantaneous passage of title from the collaborators to Pratt & Whitney at that moment or instant in time, if you will.' … Thus, there is no question but that Pratt does obtain title to the parts.

Further, 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. The Board noted that all of the collaboration agreements save one 'provide[d] that the sharing of gross revenues from the sale of engines and parts will be 'in consideration of the parts manufactured.' ' … The contracts also expressly linked the receipt of revenue share payments to the delivery of a collaborator's program share of production. *The fact that a particular revenue share was not assigned as a matter of internal accounting to individual parts and that the revenue share per part during any particular time period might have been greater or lesser depending on a variety of factors did not prevent the payments from constituting a price.*
[Emphasis added.] Thus, 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. The express language of Pratt's contracts, which make clear that the parts suppliers are 'independent contractors' of Pratt, supports this conclusion. In 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.

Judge Dyk singlehandedly threw out the use of experts to assist triers of fact in understanding the complex worlds of CAS and cost accounting-areas in which but a handful of attorneys have any real expertise. That cleared the field for what, in our view, became a rather circuitous and frankly, incredible, journey to find a definition of "cost" that he could use to overturn the ASBCA decision. And attorneys trying complex CAS cases have had to live with the use of "dictionary definitions" of terms ever since-to the detriment of their clients and to the detriment of equity and justice.

Moreover, in another (related) ruling, Judge Dyk threw out UTC's estoppel arguments, thus paving the way for the Government to ignore a contractor's Disclosure Statement language regarding its cost accounting practices, even though government auditors routinely torture contractors for weeks or months (or sometimes years) over "adequacy" and "compliance" of those Disclosure Statements and those cost accounting practices. Before this decision, we used to preach to contractors that they should include as much detail in their Disclosure Statements as possible, to establish estoppel arguments should they become necessary. After this decision? Not so much.

In issuing this important decision, Judge Dyk set the complex world of CAS litigation back a generation or two and personally created a new Dark Age where attorneys and judges have to feel their way through the CAS and FAR regulations without an expert to help guide them.

"Black Hawk Dawn" wanted to know what the definition of "cost" was for government contract cost accounting purposes. It's taken us a while to get to this point, but now you are ready to hear the answer to her question.

Use a dictionary. Everything you need to know to understand the term is there. Don't believe us? Just ask Judge Dyk.