

ALLOCATING B&P: DIRECT OR INDIRECT?

THE CONFUSION CONTINUES

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ABSTRACT

The allocation of B&P costs is oftentimes misunderstood and improperly applied. This article provides an analysis of Interpretation No. 1 to CAS 402. Interpretation No. 1 was intended to clarify when B&P costs could be charged as a direct cost to an existing contract. However, the results of several court cases have led to further confusion in this area. It is hoped that by looking at the CASB rationale when they issued Interpretation No. 1, this article will shed some light on when B&P may be allocated direct and when it may be allocated indirect.

The proper allocation of B&P costs affects both Government Program Managers and Government Contractors. Many people believe that all B&P costs are charged only to overhead. In some cases they are indirect costs, in others they are not. For Program Managers improper allocation of B&P costs could result in excess charges to your program. For Government Contractors, failure to know when or how to properly allocate B&P costs could result in a charge of non-compliance and possible litigation.

Prior to the issuance of Cost Accounting Standard (CAS) 402, it was common for contractors to subjectively charge bid and proposal (B&P) costs as both direct and indirect charges to contracts. This resulted in the overcharging of some cost objectives and double counting.

When the Cost Accounting Standards Board (CASB) implemented Cost Accounting Standard (CAS) 402, they attempted to prevent

9904.404-61 Interpretation

(a) **9904.402 Cost Accounting Standard-- Consistency in Allocating Costs Incurred for the Same Purpose**, provides, in 9904.402-40, that " *** no final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included in any indirect cost pool to be allocated to that or any other final cost objective."

(b) This interpretation deals with the way 9904.402 applies to the treatment of costs incurred in preparing, submitting, and supporting proposals. In essence, it is addressed to whether or not, under the Standard, all such costs are incurred for the same purpose, in like circumstances.

(c) Under 9904.402 costs incurred in preparing, submitting, and supporting proposals pursuant to a specific requirement of an existing contract are considered to have been incurred in different circumstances from the circumstances under which costs are incurred in preparing proposals which do not result from such specific requirement. The circumstances are different because the costs of preparing proposals specifically required by the provisions of an existing contract relate only to that contract while other proposal costs relate to all work of the contractor.

(d) This interpretation does not preclude the allocation, as indirect costs, of costs incurred in preparing all proposals. The cost accounting practices used by the contractor, however, must be followed consistently and the method used to reallocate such costs, of course, must provide an equitable distribution to all final cost objectives.

the practice of double counting. Double counting occurs when costs are incurred for the same purpose in like circumstances and then sometimes allocated as a direct cost and sometimes allocated as an indirect cost. The purpose of the standard was to insure that each type of cost is allocated only once and on only one basis (either direct or indirect) to any contract or other cost objective. Therefore, all costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only with respect to the final cost objective.

Following the promulgation of CAS 402, auditors from the Defense Contract Audit Agency started challenging contractors that were charging B&P costs as both a direct and indirect cost as being in noncompliance with the standard.

A common issue of dispute centered on B&P costs incurred to obtain follow on contracts.

In some cases, the terms of the existing contract required the contractor to bid for a follow on contract. In other cases, the terms of the existing contract implied that contractors were expected to bid on follow on work, but there was no clear specific requirement to do so.

Prior to promulgation of Interpretation 1 to CAS 402, B&P costs for an existing contract could clearly be direct charged, as it fit the regulatory definition for direct costs. CAS 402 defines a direct cost as "any cost which is identified specifically with a particular final cost objective."

Therefore, bid costs for change orders, letter contracts, and unpriced ordering agreements appeared to fit the criteria for direct charging of bid costs. However, the issue was less clear when there was no existing contract. Could a contractor direct charge B&P to a proposal which proved successful in obtaining an award? The costs are clearly identifiable with the contract. Is this an example of valid pre-contract (direct) costs? Would B&P costs for a follow on contract fit the definition of a direct charge? These problems become particularly troubling when we consider

that the follow on contract does not exist at the time the B&P is incurred. Can a contractor charge incurred B&P costs for the follow on effort to the initial contract, a contract which does exist? The answer is yes, if the B&P fits the regulatory definition of direct costs; those which are "identifiable with a particular final cost objective." The issue then becomes, is the cost identifiable with a particular final cost objective? Does a requirement exist which would make it identifiable? These issues caused a lot of controversy because contractors believed that some B&P costs should be charged direct since the costs could be specifically identified to an existing contract. However, the wording of CAS 402 that all costs incurred for the same purpose, in like circumstances must be charged the same way, either direct or indirect, in addition to the Board's stated purpose of preventing double counting, led auditors to believe that the contractors must treat B&P costs as either direct or indirect only.

In order to resolve the dispute, the CASB was asked to clarify if, and under what circumstances, B&P costs could be charged as direct costs.

The CASB issued a proposed interpretation in the Federal Register and received written comments from contractors, Government agencies, industry and professional associations and others.

The interpretation addressed whether or not, under the Standard, all B&P costs are incurred for the same purpose, in like circumstances. The CASB concluded that "costs incurred in preparing, submitting, and supporting proposals pursuant to a specific requirement of an existing contract are considered to have been incurred in different circumstances from the circumstances under which costs are incurred in preparing proposals which do not result from such specific requirement." Therefore, all B&P costs were deemed to have been incurred for the same purpose, i.e. for B&P, however, the circumstances are different when there is a specific

requirement in an existing contract, and thus the B&P costs may be treated differently. The Board's rationale was that "the circumstances are different because the costs of preparing proposals specifically required by the provisions of an existing contract relate only to that contract while other proposal costs relate to all work of the contractor."

In the introductory comments on promulgation of Interpretation No. 1 to CAS 402, the Board explained ; "The most prevalent comments received dealt with costs incurred in preparing a follow-on proposal which is not specifically required by an existing contract. Many Commentators suggested that the words "specific requirement" be deleted and that in lieu thereof, words such as "related to," "arising from," "identified with," or "directly associated with," be used. Other commentators, while agreeing that the "specific requirement" provision should be retained, suggested an expansion to also cover proposals for follow-on contracts. Still other commentators, however, believed that the "specific requirement," provision was appropriate and should be retained without addition or other change." The Board further explained; "the distinguishing characteristic noted by the (CAS) Board for determining if circumstances can be considered to be different with respect to costs incurred in preparing two proposals was whether one proposal was prepared pursuant to a specific requirement of an existing contract while the other was not. The Board continues in its belief that the "specific requirement" provision is the distinguishing characteristic and , accordingly, has retained this provision in the interpretation being published today."

While this interpretation was intended to resolve a long-standing area of controversy regarding the charging of B&P costs, there is still confusion in this area as exemplified by the court's misapplication of Interpretation 1 in the following cases.

THE BOEING CASES

In ASBCA case No. 29793, dated 3 Dec. 1987, Boeing appealed a contracting officer's final decision directing them to remove B&P costs recorded as indirect and re-record them as direct. It was undisputed that the Phase 1 contract required Boeing to prepare and submit a proposal to obtain a Phase 2 contract. The dispute arose over proposal preparation costs that Boeing had incurred in anticipation of the follow on contract before receiving the Government's proposal instruction package (PIP).

Boeing argued that it had no contractual obligation to prepare its Phase 2 proposal under the Phase 1 contract until the Government issued the PIP because the contract specifically stated that "the proposal content will be specified at a later date." According to CAS 402 the contractor could not charge the costs direct until there was a specific requirement on the existing contract and until the Government issued the PIP there was no specific requirement. Therefore it was proper under CAS 402 to treat some of its costs as indirect and some as direct.

The Government argued that Boeing as an experienced contractor must have known what the proposal requirements were going to be and that it had no contractual interest as to when Boeing prepared its proposal only that it prepare and submit one on time. Therefore all the costs that Boeing expended for the Phase 2 contract were directly related to the follow on contract and should be direct charged to the existing contract. According to CAS 402 all of the costs were incurred for the same purpose, in like circumstances and therefore the B&P costs must be charged either direct or indirect only. To do otherwise would be double-counting.

The ASBCA ruled in favor of the Government. In doing so it relied on the CAS Board's explanation of Interpretation 1 to CAS 402. In evaluating and rejecting Boeing's argument, the

ASBCA stated that the B&P costs “are part of the costs of competition caused or generated by the contract requiring the submission of a proposal for a follow on contract and must be treated in the same fashion as proposal preparation costs as a result of the consistency requirements of CAS 402.” The wording of this decision by the Board was critical and became the basis for reversal by the Court of Appeals.

THE COURT OF APPEALS REVERSAL

In 88-1298, the Court of Appeals reversed the ASBCA’s decision. Thus Boeing was allowed to split B&P costs for follow on work related to a specific contract.

In issuing its decision, the Court of Appeals relied on the CASB’s explanation of Interpretation 1 to CAS 402 and used it to reverse the Board’s decision. The Court stated “ The Board erred as a matter of law in interpreting CAS 402 to require like accounting for B&P costs “related to” or “caused or generated” by a contract and B&P costs “specifically required” by a contract. In interpreting CAS 402, the CASB used the words “specific requirement of an existing contract” to distinguish between proposals in different circumstances. During the comment period on Interpretation 1, the CASB was requested to change the “specifically required” language to “related to,” “arising from,” or the like. The CASB refused, maintaining that the “specific requirement” provision is the distinguishing characteristic for determining if circumstances can be considered different with respect to allocating costs directly or indirectly.”

Based on the CASB’s explanation, the Court determined that “only the B&P costs incurred between the Phase 2 PIP receipt and Phase 2 proposal submission were specifically required by the existing contract. It is here that the court made its first error. It confused the concepts between what made the circumstances different and the costs of preparing the proposal

that relate to the existing contract. In both cases the distinguishing characteristic is a specific requirement.

The court was apparently unaware that the critical language taken from the CASB comments, and quoted in its decision, was taken out of context and misinterpreted due to the omission of the sentence which immediately preceded it. That sentence is, "The most prevalent comments received dealt with costs incurred in preparing a follow on proposal which is not specifically required by an existing contract." In the instant case the costs that were not specifically required were those incurred before the PIP was received by Boeing. What the Court did was to grab on to the oft quoted language without considering the issue raised in the omitted sentence and the Board's rationale in promulgating CAS 402. The CAS Board's language was never intended to differentiate between costs incurred when preparing the same proposal. What the CAS Board stated was that the circumstances can be considered to be different with respect to costs incurred in preparing a proposal if the proposal was prepared pursuant to a specific requirement of an existing contract. Therefore, if there is a specific requirement on an existing contract to prepare a follow on proposal, the costs incurred in preparing that proposal may be direct charged to the existing contract. This point is supported by the express language of the interpretation wherein the Board's stated rationale was that "The circumstances are different because the costs of preparing proposals specifically required by the provisions of an existing contract relate only to that contract while other proposal costs relate to all work of the contractor." (emphasis added). What the Board intended was that all costs of preparing the follow on proposal are related to the existing contract and may be charged direct when there is a specific requirement in the existing contract for a follow on proposal. To infer otherwise is to disregard the rationale the CASB provided that the reason the circumstances are different is

because other proposal costs i.e. without a specific requirement, relate to all work of the contractor and thus are indirect costs.

Clearly in the Boeing case the proposal preparation costs incurred prior to the PIP do not relate "to all work of the contractor." Those costs are directly related to the existing contract. In this case, the regulatory definition of direct costs requires a cost identifiable with a specific contract to be charged direct.¹ To imply otherwise would leave those costs as indirect costs allocated to all work of the contractor when, in fact, they can be clearly identified to this specific contract. In essence, other contracts would be subsidizing the B&P effort for the follow on contract and would create a double counting situation. Further, to treat these costs otherwise would not address the concern that the CASB had regarding those follow on proposal costs that were not specifically required by an existing contract and is totally inconsistent with the CASB rationale. After all, CAS 402 was intended to provide consistency in allocating costs incurred for the same purpose, in like circumstances.

Without considering the omitted sentence regarding costs not specifically required by an existing contract in conjunction with the Board's rationale for why the circumstances are different, the Court erred in its decision.

A second error made by the court was due to excessive language quoted by the court in its decision. The Court repeatedly stated "the specific requirement provision is the distinguishing characteristic for determining if circumstances can be considered different with

¹ Interpretation 1 does create one exception to compliance with the regulatory definition of direct costs. The last paragraph, paragraph (d), allows any contractor the option of having a disclosed practice of treating all B&P costs as indirect. In this exception, any contractor that elects this option, must charge all B&P indirect even though there is a contractual requirement for B&P effort. This has created unusual situations in joint venture contracting. In these cases, when the existing contract has a specific requirement for B&P effort for the follow on, one party to the joint venture may charge their B&P expense direct, while the other party may charge B&P indirect.

respect to allocating costs directly or indirectly.” After making this point abundantly clear, and using this point to reverse the Board’s decision, the Court read part of Boeing’s accounting procedure, which was not at issue, into its decision. It stated “Boeing, with two exceptions, allocates all B&P costs indirectly. (1) If the proposal is a follow on to an existing single source, i.e., noncompetitive, contract or (2) is a proposal specifically required by an existing contract, Boeing allocates the costs directly to the existing contract... Boeing’s accounting practices, if followed consistently, comply with CAS 402.” Because Boeing followed consistently its established accounting practices and those practices comply with CAS 402, the Board’s decision is reversed.”

It is clear that the first practice does not comply with CAS 402. When there is no specific requirement, the B&P costs cannot be charged direct. Additionally, the first practice is exactly the issue the CASB was addressing when it rejected direct charging of a follow on contract. Unfortunately, this first statement, taken from Boeing’s accounting procedures, is now dicta and has been relied on by other contractors. The first practice was not examined by the court, it contains language that is extraneous to the decision, and is clearly in non-compliance with CAS 402.

This issue of direct charging follow on proposal preparation costs to the existing contract also came up in Bell-Boeing Joint Venture, ASBCA No. 39681, dated 27 May 1993. The court recognized the issue but did not rule on it because the case developed into the dual issues of PCO vs. ACO authority in determining CAS issues and the Contractor’s reliance on a CACO determination. Although the CACO had made a written determination that Boeing’s disclosed treatment of B&P was acceptable, the PCO disallowed Boeing’s direct charged B&P for a follow on contract on the basis of a CAS 402 noncompliance. As a result, even though the litigation

started from differing interpretations in direct charging of B&P costs, the case was decided with no added guidance on direct charging of B&P costs.

It is unfortunate that the ASBCA did not have the opportunity to take another look at this issue and to perhaps provide a truly consistent method of allocating B&P costs.

CONCLUSION

Currently, Contractors can direct charge B&P costs when: (1) the Contractor's disclosure statement provides for direct charging of B&P in accordance with the criteria established in Interpretation 1 to CAS 402, and (2) the costs are specifically required by an existing contract. B&P costs necessary to definitize letter contracts, change orders, and unpriced ordering agreements also appear to meet this criteria. In these cases, even though the explicit "specific requirement" language may be absent from the contract, there is an implicit requirement in the contract. B&P costs incurred for follow on contracts cannot be charged direct to the existing contract, unless the contract terms specifically require the contractor to perform the work. In this case, the B&P becomes required contractual effort.