THE GOVERNMENT CONTRACTOR®

THOMSON WEST

Information and Analysis on Legal Aspects of Procurement

Vol. 48, No. 9 March 8, 2006

Focus

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PRACTITIONER'S COMMENT: "Benefit" Test For CAS 418 Homogeneity

Appeals of AM General LLC, ASBCA Nos. 53610 & 54741, 2006 WL 280634 (Feb. 2, 2006)

On Feb. 2, 2006, the Armed Services Board of Contract Appeals issued an important decision about the CAS 418 "homogeneity" requirement for indirect cost pools. In *AM General,* the Board concluded that the contractor's single overhead pool of combined military and commercial production violated CAS 418 homogeneity requirements because the military business did not "benefit" from the costs of a facility that housed only commercial production activities. Although the threshold holding that the contracts at issue are subject to the Cost Accounting Standards is open to debate, subsequent regulatory changes reduce the risk that a contract exempt from the Truth in Negotiations Act (TINA) could, nevertheless, be subject to CAS. The rationale for the Board's decision on CAS 418, however, is inconsistent with both the text and the regulatory history of the Standard, and, interpreted literally, could cause significant problems for contractors.

AM General Facts—AM General has manufactured the High Mobility Multipurpose Wheeled Vehicles (HUMMWVs or Humvees®) for the military since approximately 1983. Beginning in the early 1990s, the Government's requirements began to decline, resulting in a significant increase in the amount of indirect operating costs allocated to each vehicle. The Army Tank-Automotive and Armaments Command (TACOM) wanted to maintain a source for Humvees, without having to pay more per vehicle. To increase its business base and reduce the average price to the Government, AM General began to sell HUMMWVs—under the trade name HUMMER®—in the commercial marketplace.

To meet AM General's minimum sustaining production rate at a price that the Government was willing to pay, the parties agreed, in principle, that the TACOM would purchase a minimum of 10 vehicles per day under a five-year requirements contract, and that AM General would sell 7.5 vehicles per day in direct foreign military sales and another 7.5 vehicles per day in the commercial market. The military vehicles would be produced entirely in the company's facility in Mishawaka, Ind. After coming off the production line in Mishawaka, the commercial HUMMERs would be "finished" at the adjacent Armour building. AM General's pricing for the military Humvees was predicated on its use of a single manufacturing overhead pool allocated on a per-vehicle basis to both military and commercial vehicles.

The dispute involved the acquisition of Humvees under three fixed-price contracts with AM General:

- Contract No. DAAE07-95-C-R021 (Contract RO21) was awarded as a letter contract on Dec. 23, 1994, and definitized on Sept. 29, 1995.
- Contract No. DAAE07-96-D-X001 (Contract X001) was awarded on Dec. 14, 1995.
- A modification to Contract No. DAAE07-89-C-0998 (Contract 0998) was definitized on June 28, 1996.

In spring 1995, before the definitization of Contract R021, modification of Contract 0998 and award of Contract X001, the Army waived the requirement for certified cost or pricing data for the Humvees, on the ground that the vehicles satisfied the new statutory definition of "commercial item" in the Federal Acquisition Streamlining Act of 1994 (FASA) (the "Decker waiver"), although no regulations implementing that new definition had been issued and there was some doubt that the Humvees would have qualified for an exemption under the existing regulations. The waiver did not apply to military-unique items procured under those contracts.

On June 26, 1995, AM General submitted a revised proposal with cost data for the Humvees, but did not certify the cost data. In the interim, the company advised the Administrative Contracting Officer that it was changing its allocation base for manufacturing overhead costs from a direct labor base to a "unit of production" base. Consistent with the methodology underlying its proposed pricing for Humvees, manufacturing overhead costs were to be accumulated in a single cost pool and allocated to both the military and commercial vehicles on a per-unit basis.

In July 1995, the Defense Contract Audit Agency issued a draft audit report objecting to the proposed change as noncompliant with CAS 418, and estimated a cost impact of about $1,650 per vehicle. TACOM accepted AM General's proposed pricing, but included in all three contracts a "reopener clause" reserving the right to make a downward price adjustment after determination of the impact of the alleged CAS 418 noncompliance.

In August 1996, after definitization of the three contracts and modifications at issue, the ACO made an initial finding of noncompliance with CAS 418. After extended discussions about the substance of the noncompliance and the method of calculating the impact on price, the successor ACO issued a final decision that AM General's use of a single indirect cost pool based on units of production violated CAS 418, and a second final decision denying AM General's claim for an offset relating to the price impact of the noncompliance. Appeals from the final decisions were consolidated.

CAS Coverage—AM General moved for summary judgment on several grounds, arguing in the first instance that the contracts at issue were exempt from CAS. The Board denied AM General's motion after a painstaking review of the sequence of statutory and regulatory changes in the late 1990s. That history is summarized completely below, but not all of the relevant history appears in the decision.

As of Nov. 4, 1993, the CAS Board eliminated the need for a separate waiver of CAS for firm-fixed-price contracts and subcontracts when an agency waived the requirement for submission of certified cost or pricing data. As amended, the regulation exempted from CAS "[f]irm-fixed price contracts and subcontracts awarded without submission of *any* cost data." 48 CFR § 9903.201-1(b)(15) (1994) (emphasis added). The CAS Board's promulgation comments included the following discussion:

> The Board has also determined that the exemption paragraph appearing at § 9904.201-1(b)(15)[sic] should be expanded to eliminate the requirement for a separate Cost Accounting Standards Board waiver in circumstances where the relevant procuring agency has determined to waive the requirement for submission of certified cost or pricing data. *The Board believes that adequate safeguards exist within the procuring agencies with respect to this issue so as to preclude the need for the approval of individual CAS contract waivers by the Board.* The elimination of this requirement should significantly ease the administrative burdens (for both the Government and contractors/subcontractors) associated with obtaining CAS coverage exemptions in those instances where the agency has already waived the requirements of the Truth in Negotiations Act, Public Law 87-653.

58 Fed. Reg. 58800 (Nov. 4, 1993) (emphasis added). On Oct. 13, 1994, Congress enacted FASA, which made numerous, wide-ranging statutory changes reducing the legal burdens for purchasing commercial items, including broadening the definition of "commercial item," an exemption from TINA and the elimination of the mandatory application of CAS to firm-fixed-price contracts or subcontracts without cost incentives for commercial items. 41 USCA § 422(f)(2)(1995). Addressing the effective date, the statute provides:

> (3) Except as otherwise provided in this Act, a law amended by this Act shall continue to be applied according to the provisions thereof as such law was in effect on the date before the date of the enactment of this Act until—
> (A) the date specified in final regulations implementing the amendment of that law (as promulgated pursuant to this section); or
> (B) *if no such date is specified in regulations, October 1, 1995.*

P.L. 103-355, § 10002(f) (emphasis added), codified at 41 USCA § 251 note.

The U.S. Comptroller General interpreted this language to mean that the statute would be effective Oct. 1, 1995 *at the latest. KPMG Peat Marwick, LLP,* Comp. Gen. Dec. B-259479, 96-2 CPD ¶ 43. Consistent with that, the Federal Acquisition Regulation was amended, effective Oct. 1, 1995, to implement many of the FASA provisions addressing the acquisition of commercial items, including the amendment

of the TINA regulations. During the regulatory review process, the FAR drafters received comments indicating that the CAS also needed to be amended:

> Several commenters stated that the Cost Accounting Standards (CAS) needed to be revised to narrow the definition of what constitutes "cost or pricing data" for purposes of CAS covered contracts. The commenters believe that until CAS is modified the coverage in the TINA rule would not completely address the issue of commercial contractors being required to expose cost data to the Government and to be accountable for such data.
>
> *The Team believes the commenters have identified a valid concern. However, the matter rests with the CAS Board as the problem is that the CAS definition of "cost data" is more broadly based than the "cost or pricing data" definition in the FAR coverage.*

60 Fed. Reg. 48211 (Sept. 18, 1995) (emphasis added).

Despite urging from both industry and Government officials, however, the CAS Board did not issue regulations implementing the FASA exemption of firm-fixed-price commercial item contracts before the effective date. Instead, on Dec. 18, 1995, more than a year after enactment, the CAS Board purported to delegate to federal agencies the authority to "waive" the application of CAS for individual firm-fixed-price contracts for commercial items, but only if "cost or pricing data" was not obtained. For purposes of CAS coverage, the phrase "cost or pricing data" in the CAS regulations was interpreted to mean *any* cost or pricing data, not just data requiring certification under TINA. *Aydin Corp. (West) v. Widnall,* 61 F.3d 1571, 1579 (Fed. Cir. 1995). Accordingly, under existing Federal Circuit precedent, a contract for a commercial item might be exempt from TINA, but subject to CAS, if the contractor submitted limited cost or pricing information in support of a price reasonableness determination, despite the clear statutory provision to the contrary.

On Feb. 10, 1996, Congress acted again, passing the Federal Acquisition Reform Act of 1996 (FARA), which included another exemption from CAS for "[c]ontracts or subcontracts for the acquisition of commercial items." P.L. 104-106, § 4205, 110 Stat. 656 (1996), codified at 41 USCA § 422(f)(2)(B)(i). In an interim rule implementing this provision, the CAS Board limited the commercial item exemption to firm-fixed-price and fixed-price with economic price adjustment contracts and subcontracts. 61 Fed. Reg. 39360 (July 29, 1996). It was more than a year after FARA that the CAS Board issued a final rule exempting "[f]irm fixed-priced and fixed-price with economic price adjustment (provided that price adjustment is not based on actual costs incurred) contracts and subcontracts for the acquisition of commercial items." 62 Fed. Reg. 31294 (June 6, 1997) (codified at 48 CFR § 9903.201-1(b)(6)). In its promulgation comments, the CAS Board expressly declined to waive retroactively CAS requirements for commercial item contracts effective after the Oct. 13, 1994 enactment of FASA, stating that the new rule, together with the waiver authority delegated in December 1995, was "sufficient to address CAS commercial item contracting issues under both FASA and FARA." Id.

Turning to AM General's arguments, the Board noted first that the "Decker waiver," which did not apply to the military-unique items provided under the contracts, was only a partial waiver of TINA. The CAS regulations in effect at the time exempted "[f]irm-fixed-price contracts and subcontracts awarded without submission of *any* cost data." 48 CFR § 9903.201-1(b)(15) (effective Nov. 4, 1993) (emphasis added). The Board also noted that, although the Army could waive TINA, only the CAS Board had the authority to waive CAS coverage on individual contracts, and it did not delegate its waiver authority until 2000. Thus, the "Decker waiver" could not have authorized the waiver of CAS, other than the exemption in the CAS Board's own regulations at 48 CFR § 9903.201-1(b)(15). Because AM General was required to submit and certify data for the military-unique items, the waiver did not exempt the contracts from CAS coverage.

Second, AM General argued that TACOM elected not to apply CAS to the contracts when it agreed to consider the Humvees to be "commercial items" and to price the Humvees using the allegedly noncompliant method of allocating manufacturing overhead. Relying on the sequence and effective dates of the relevant statutory and regulatory provisions, the Board found that TACOM could not have elected to exempt the contracts from CAS, even if it had intended to do so.

- Contract R021 was definitized on Sept. 29, 1995, after the enactment of FASA but before the effective date of its implementation in the FAR or by the CASB, either in the form of waiver authority or as an exemption for commercial item contracts.

- Contract X001 was awarded on Dec. 14, 1995, after the effective date of the implementation of FASA in the FAR but before the CASB implementation of FASA, either in the form of waiver authority or as an exemption for commercial item contracts. Even had the waiver authority existed, it would not have covered Contract X001 because AM General had submitted cost or pricing data for the military-unique items.
- The modification to Contract 0998 was definitized on June 28, 1996, after the enactment of both FASA and FARA, and after the CASB delegation of waiver authority, but prior to the CASB's regulations providing for an exemption for commercial item contracts. Again, the waiver authority did not cover the modification to Contract 0998 because AM General submitted cost or pricing data for the military-unique items.

Under the facts of this case—i.e., where the contracts at issue included military-unique items in addition to the Humvees that the Army deemed "commercial items"—the Board's conclusion that the contracts were CAS-covered may well be correct. However, because the issue apparently was never raised, the opinion does not address the legal consequences of the CAS Board's inexplicable delay in implementing the statutory exemptions. It was nearly three years after the enactment of the statutory exemption in FASA, nearly two years after the latest effective date for the regulations identified in the statute, and nearly six months after the enactment of FARA.

Although an agency generally has broad discretion when issuing regulations, "[i]f the intent of Congress is clear ... the unambiguously expressed intent of Congress" must be given effect. *Chevron USA, Inc. v. Natural Resources Defense Council,* 467 U.S. 837 (1984). Whether, under the *Chevron* standard, the CAS Board had the statutory authority (a) to refuse to amend its regulations in the face of express statutory direction to do so and (b) to deny retroactive effect to those regulations once they were promulgated are important issues that the Board should have had the opportunity to address.

The Board may also face an interesting and novel argument when it turns to quantum in the next stage of the case. The Government is entitled to recover the "increased costs" paid because of any noncompliance. When a contract is negotiated in reliance on certified cost or pricing data, there is typically an audit trail creating a baseline to determine what the impact would have been. In this case, however, the price was negotiated primarily on a commercial item basis, without certified data. Some cost information was provided to the Government, but it is not clear from the decision how, if at all, the Government relied on that information in determining the contract price. The decision indicates that AM General argued that the Government cannot prove the overhead allocation issue would have changed the price negotiated. If the price of the vehicles was negotiated on a bottom-line commercial price basis, it may be difficult for the Government to prove that any CAS violation affected the negotiated price.

CAS 418—As troubling as the Board's incomplete analysis of the CAS coverage issue may be, at least the precedential effect of that portion of the decision was short-lived because the CAS Board since has conformed its regulations to the requirements of the statute. The impact of the Board's decision on pending and future disagreements about the meaning of CAS 418 is much more significant.

The Board's logic has a certain appeal because it is so simple: No activity related in any way to production of Government vehicles occurs in the Armour building; therefore, none of the cost of that building benefits the Government. In the Board's view, because the cost pool is not homogeneous, the cost of the Armour building cannot be allocated to Government contracts under CAS 418. It is possible that this conclusion would be supported by a more thorough analysis of the facts, but the facts reported in the decision are not sufficient evidence that the creation of a single pool encompassing the cost of the Armour building violated the requirements of CAS 418. This was not a case to decide on motions for summary judgment.

The Board's decision relies on a common-sense reading of the word "benefit" that is not justified in the context of a dispute about allocability under CAS. In *Boeing North American v. Roche*, 298 F.3d 1274 (Fed. Cir. 2002), after surveying the long and tortuous history of the word "benefit" in its prior decisions about Government contract accounting, the Federal Circuit concluded:

> Thus, we agree with Boeing that allocability is an accounting concept and that CAS does not require that a cost directly benefit the government's interests for the cost to be allocable. The word

> "benefit" is used in the allocability provisions to describe the nexus required for accounting purposes between the cost and the contract to which it is allocated. The requirement of a "benefit" to a government contract is not designed to permit contracting officers, the Board, or this court to embark on an amorphous inquiry into whether a particular cost sufficiently "benefits" the government so that the cost should be recoverable from the government. The question whether a cost should be recoverable as a matter of policy is to be undertaken by applying the specific allowability regulations, which embody the government's view, as a matter of "policy," as to whether the contractor may permissibly charge particular costs to the government (if they are otherwise allocable).

Id. at 1284. The question in this or any other cost-allocation case is not whether the cost at issue "benefits" the Government in the traditional meaning of the word. It is whether regulations permit the contractor to allocate the cost to Government contracts as a matter of policy. The Board's decision does not address the relevant requirements of the regulation.

Homogeneity under CAS 418 is determined based on one of two criteria.

> An indirect cost pool is homogeneous if each significant activity whose costs are included therein has the same or a similar beneficial or causal relationship to cost objectives as the other activities whose costs are included in the cost pool. It is also homogeneous if the allocation of the costs of the activities included in the cost pool result in an allocation to cost objectives which is not materially different from the allocation that would result if the costs of the activities were allocated separately.

48 CFR § 9904.418-50(b)(1). If an overhead pool satisfies either criterion, it is homogeneous. Put another way, to establish that a pool is not homogeneous, the Government must prove *both* that the activities in the pool do not have a similar relationship to the activities in the base *and* that a different allocation of costs would produce a materially different result. The Board misapplies the first standard and ignores the second.

Relationship Between Pool Costs and Base Activities: No case has held that CAS 418 is violated because an identifiable element of cost in the overhead pool does not specifically "benefit" some of the cost objectives in the base. On the contrary, in the only other reported case about the requirements of CAS 418, the contractor had a single overhead pool that covered multiple, distinct facilities. *Litton Sys., Inc.,* ASBCA Nos. 37131 & 37137, 94-2 BCA ¶ 26,731. In *Litton*, the Government argued that Litton's pools and rates did not comply with CAS 418 precisely because they covered separate facilities under different divisions. Citing the criteria in the Standard, the Board held that the Government did not meet its burden of proof in arguing that the cost pool violated the homogeneity requirements.

Litton is primarily a burden of proof case. The Board cites *Litton* in the *AM General* decision to establish that the Government has the burden of proof in CAS 418 cases. However, considering the facts in *Litton*, it is likely that some of the costs in the pool did not specifically benefit contracts being performed in separate locations by different divisions. In *AM General*, the contractor apparently did not argue, and the Board apparently did not consider, that the substantive holding in *Litton*—a single multi-facility pool complied with the homogeneity requirements of CAS 418—is relevant to the analysis.

The regulation does not require that every cost in the pool must "benefit" every activity in the allocation base. Such a requirement would create horrific administrative problems. Many contractors have large manufacturing overhead pools that include the costs of all capital equipment and all supervision, with all manufacturing direct labor in the allocation base. Obviously, it would be virtually impossible for every piece of equipment included in a plant-wide pool to "benefit" every contract in the allocation base, but that is essentially the standard the Board applies in *AM General*. Because a specific and identifiable element of cost included in the pool played no role in performing any Government contract, the Board held that the cost of that facility was not allocable to Government contracts.

As this PRACTITIONER'S COMMENT will explain, even the Board's seemingly obvious conclusion about the common-sense understanding of the term "benefit" is questionable, and its analysis of the requirements of CAS 418 is wrong. The issue here is whether the costs in the pool have the same or similar relationship to the cost objectives. As a practical matter, the manufacturing overhead pool for any sizable manufacturing operation will necessarily include some costs that do not benefit some cost objectives.

In a typical factory engaged in the production of goods, there are dozens, or even hundreds, of pieces of major capital equipment. Some of that equipment may be used exclusively to make a single product for a time. In theory, a contractor could keep track of when each machine is being used for any single product and allocate the cost of the machine to the product for that period. Under the Board's reading of the regulation, there is a real risk that the Government will try to insist on such record-keeping when multiple pools or, even worse, direct charging to specific contracts, would be to the Government's benefit.

Contractors must have a full complement of assets to perform their business. Some of those assets may be idle from time to time; some may be used for specific production under specific contracts for a period of time. Ultimately, however, all assets used in the production of related products "benefit" all of the business in much the same way. Focusing on specific usage of specific assets simply is not workable—nor is it required by CAS 418.

Relying solely on the facts and analysis in the Board's decision, it is impossible to determine whether the AM General pool at issue is "homogeneous." The Board decision reveals only that there was a physically separate "finishing" facility for commercial vehicles, while military vehicle "finishing" took place in the manufacturing facility. Government lawyers familiar with the case have stated that "finishing" means painting. Apparently, it was the Government's view that (1) the indirect cost of painting the commercial vehicles was more expensive than the cost of painting military vehicles and (2) it should not be responsible for any portion of that cost.

Without more facts—if there are any—about the differences between the facilities and the activities that occur in them, it also is impossible to determine whether the Board's ultimate conclusion that the pool is not homogeneous is consistent with CAS 418. This conclusion seems to be based on the simple fact that the commercial finishing was performed in a different location where the costs were higher. Not only is this not the test for homogeneity under CAS 418, but applying this test could produce unfair results.

For example, it appears from what is known that the military production line was in place years before AM General introduced its commercial product line. Common sense suggests that the newer commercial facility would be more expensive than the older military facility. If the "finishing" work and the equipment used in both facilities is similar, the homogeneity requirements of CAS 418 are met. If the primary differences between the commercial facility and the military facility are that the commercial facility is newer and had a higher net book value for equipment comparable to the equipment in the military facility, then the Board's finding almost certainly is not consistent with the letter or spirit of CAS 418.

There also is reason to doubt the apparently uncontested assumption that the commercial facility did not "benefit" the Government. Since the contractor developed a commercial derivative for the specific purpose of reducing the average cost per vehicle to the Government, the average per-vehicle cost to the Government decreased because the contractor invested in commercial production. If one result of the contractor's investment in the commercial finishing facility was reduced costs for its military vehicles, there was a real and tangible benefit to the Government.

Whether there is specific "benefit" to the Government is, however, not the question under the first test for compliance with CAS 418. The first test for compliance requires an analysis of the relationship between the activities included in the pool and the cost objectives in the base, which the Board simply did not address.

Materiality: The Board also failed to address the second CAS 418 compliance test: Would the allocation of costs in separate pools materially change the allocation of cost objectives? While it expressed some sympathy for the Government's quantum argument, the Board specifically refused to decide the Government's request for summary judgment on that issue. Other than the Government argument regarding the cost impact of the alleged CAS 418 noncompliance, there is no reference in the decision to any evidence relevant to materiality.

The materiality test for compliance with CAS 418 is important, as the drafting history of the Standard demonstrates. What is now CAS 418 was originally proposed as five separate standards. 43 Fed. Reg. 11118 (March 16, 1978). Although that proposal contained no materiality provision, it did have detailed requirements for defining overhead pools. The Board subsequently reported that the public comments on the original proposal expressed great concern that, if adopted as proposed, the standards would result in "unnecessary proliferation" of overhead pools.

The Board's second proposal was for three standards, cutting back on the detailed requirements of the original proposal and adding a materiality test. 44 Fed. Reg. 42988 (July 23, 1979). The Board proposed that if separate allocation of costs did not change the amount of costs allocated to a specific cost objective by more than five percent, the impact was not material and separate allocation was not required. When the Board published the final rule, it reduced the requirements to a single standard. While the final standard did not include the five-percent test, it continued to emphasize "the necessity to evaluate any perceived need for change in cost accounting practices in terms of materiality" under the general rules about materiality. 45 Fed. Reg. 31929 (May 15, 1980). The general rules about materiality are now codified at 48 CFR § 9903.305.

Although the Board cites the *Litton* case, in which it held that the Government failed to carry its burden of proof on demonstrating the materiality of the alleged noncompliance, its decision in *AM General* ignores the materiality requirement of the standard in that decision. The materiality rules in § 9903.305 are not even mentioned, much less analyzed. It is impossible, based on the information in the decision, to reach a conclusion about any potential material impact.

Given the requirement that the impact of separate allocation must be material to prove noncompliance with CAS 418, we do not believe that any board or court could ever find noncompliance with CAS 418 on a motion for summary judgment without determining quantum and analyzing the materiality of that quantum. In this case, the Board held that the quantum issue could not be decided on motions for summary judgment and simply ignored the fact that, without quantum, what is material cannot be known.

Conclusion—This case demonstrates the risk associated with deciding important legal issues on motions for summary judgment. In fairness to the Board, it appears that the decision ignores some issues because they were not raised by the parties or contested by the contractor. The contractor seems to have focused primarily on the threshold issue of whether the contract was CAS-covered and largely failed to address the substantive issues related to compliance, perhaps because it assumed that the Board could not possibly reach these issues on summary judgment. Until these issues are relitigated in another case, where the Board or a court hears all the arguments and addresses all the issues, this case will be a problem. It will encourage DCAA to cherry-pick indirect cost pools for costs that "benefit" only commercial business, ignoring the actual requirements of CAS 418. It likely also will create new disputes and revive old ones that were resolved in negotiation based on a correct analysis of the CAS 418 tests for noncompliance.

In many ways, the most unfortunate feature of the decision is that it will inevitably lead to more confusion about what "benefit" means in the context of Government contract accounting. The case ignores the Federal Circuit's admonition in *Boeing North American* to decide cases based on the language in the regulation and avoid "embark[ing] on an amorphous inquiry into whether a particular cost sufficiently 'benefits' the government" to be allocable. *Boeing North American, Inc. v. Roche*, 298 F.3d at 1284. Ultimately, the Board may be right, and the AM General practice may violate CAS 418, but the rationale offered in this decision does not justify the conclusion.

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