

COST ALLOWABILITY OF USING DEVELOPMENT DOLLARS FOR VALUE ENGINEERING CHANGE PROPOSALS (VECP'S)

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ABSTRACT

This paper covers the proposed major revision to the Federal Acquisition Regulation (FAR) in 48.101 (b) to clarify the allowability of costs for unaccepted Value Engineering Change Proposals (VECP). The allowability of the costs will be determined in accordance with Part 31.

INTRODUCTION

The issue of "Cost Allowability" has haunted the Government/Contractor VE program for the past 10 years. The reason for this is that FAR 48.101 (b) has been incorrectly interpreted to mean that contractors costs associated with work on an unaccepted VECP is unallowable. The confusion stems from the phrases "the contractor uses his own resources to develop and submit any VECP" and "This voluntary approach should not in itself increase costs to the Government.

Why has this problem taken so long to get clarification? I think the reason is that the subject is hard to explain and even harder to understand. It appears that almost every branch of the Government is promoting contractor participation in voluntary VE development activities but at the same time the VE Clauses continue to dis-incentivize contractors by disallowing development costs.

INTERWOVEN ISSUES

There are at least nine separate but interwoven issues that has caused the long delays. These issues can best be expressed as questions:

1. What is indirect and direct costs as they relate to VE?
2. What is the allowability of those costs, whether direct or indirect?
3. What constitutes "reasonable and allocable costs?"
4. What are "activities reasonably undertaken?"
5. What are "own resources"?
6. Should the costs be included in the calculation of VECP savings?
7. How are the costs to be handled for non-accepted and accepted VECPs?
8. What costs should be used for developing, proposing and implementing the VECP?
9. What is the cost impact on VECPs if the contract is reimbursable, incentive or fixed?

HISTORY

The "cost allowability" issue first came up during an audit at Hughes Aircraft Company in 1981 by the local Defense Contract Audit Agency (DCAA). The first Defense Acquisition Regulation (DAR 83-68) case was opened in October of 1983 when other companies (Westinghouse, Raytheon, Honeywell and others) joined Hughes in taking a stand against the DCAA interpretation. The main thrust of this case was to make an explicit statement that unsuccessful VE development costs are allowable overhead costs. At that time the Cost Principles Subcommittee concluded that the current coverage provides contractors with an adequate incentive to pursue voluntary VE cost savings opportunities and any changes to the DAR would not be necessary.

Prior to 1981, VE development effort was charged to overhead as an indirect charge, whether the VECP was accepted or not. The new interpretation will change this approach, greatly increasing the risk to the contractor to the point where it would not be beneficial or profitable for contractors to spend large sums of money on VE activities.

INITIAL RECOMMENDATIONS

The Electronic Industries Association, Value Management Group continued to pursue the issue and in 1985 the case was changed to Federal Acquisition Regulation (FAR) case 85-257. This time the DAR Council asked the Cost Principles Subcommittee to review the industries arguments. The subcommittee reported that language specifically making unaccepted VECP costs unallowable be added in the FAR cost principles and VE Clauses. The initial recommendations for change were:

1. Classify VECP costs in three categories, i.e., development, proposal, and implementation costs.
2. Make development costs specifically allowable as indirect costs, which will not be included in the calculation of VECP savings.
3. Make proposal and implementation costs specifically allowable as direct costs, which will be included in the calculation of VECP savings.
4. Require an advance agreement with a contractor whose voluntary VE development activities are expected to be \$100,000 or more per year.

VIEWS FROM THE DEPUTY SECRETARY OF DEFENSE

The Deputy Secretary of Defense in a memorandum in March 1986 stated that, "It is evident that there is significant untapped potential in the Contractor VE Program. Recent briefings to the Defense Council on Integrity and Management Improvement indicated that only 14 out of 73 Selected Acquisition Report (SAR) programs in FY 1984 had any VE activity.

THE INSPECTOR GENERAL TAKES A POSITION

The DoD Inspector General has reported that the DoD Contractors VE Program is yielding only a third or less of its potential. Actions are needed to strengthen this program. Expanded use of the VE program requirement and increased emphasis from government personnel should result in capturing more of the VE potential as well as support continuing acquisition streamlining efforts during the production phase." Because the voluntary clause required the contractor to fund a proposal to a potentially unreceptive customer, contractors rarely devoted sufficient resources to VE."

THE SENATE HEARINGS ON VALUE ENGINEERING

In April 1987 the Senate Oversight of Government Management Subcommittee of the Committee of Governmental Affairs held a hearing to find out how the Government can reduce its costs through greater use of the VE program. The conclusion of the subcommittee can be summed up by its final statement: "Given the fact that contractors cannot recover the cost of any VE efforts not accepted by the government, and given that less than half of those VE proposals are in fact accepted -- it is not hard to see why VE efforts are not voluntarily done on many contracts."

DAR COUNCIL TAKES ACTION

Based upon the VE Subcommittee report and pressure from the Senate Subcommittee, the DAR Council tasked the Cost Principles Subcommittee in October 1987 to draft coverage for allowability of costs associated with an unaccepted VECP submitted by the contractor, but that certain controls or limits would be needed to bound the amount of costs allowable.

OFFICE OF FEDERAL PROCUREMENT POLICY STEPS IN

In parallel with the DAR Council actions and as a direct result of the hearing, the Administrator, Office of Federal Procurement Policy, agreed to establish implementation guidance, which was effected by Office of Management and Budget (OMB) Circular A-131 dated 26 January 1988.

THE RECOMMENDATIONS BY THE COST PRINCIPLES SUBCOMMITTEE

The Cost Principles Subcommittee's recommendations were:

1. Cost Control - Advance Agreement

Controls should be placed on the Contractor for the amount of allowable VECP costs. If this is not done the contractor would have a blank check to charge an unlimited amount to development funds. The local contracting officer is in a position to apply reasonable, judgmental oversight to contractor expenditures for voluntary VECP projects. The threshold amount for VE development costs when the threshold is expected to be met will be \$100,000 per profit center. The Advanced Agreement must be done before the fact, not after.

2. Direct/Indirect Classification

There will be no distinction between Development Costs and Proposal Costs. Both categories will be treated as indirect costs.

3. Cost Identification

VE costs will be accounted for on a project-by-project basis as though the VECP project were under contract. The costs will be burdened with applicable overhead.

4. VECP Implementation Costs

VECP implementation costs are direct costs by definition and their allowability is to be determined in the same manner as any other direct costs.

5. Allowability of Costs

Allowability of costs is more appropriately addressed in the

cost principles (FAR Part 31) section rather than in FAR Part 48. Therefore, FAR Part 48 covering allowability or accounting treatment of VECP costs will be deleted and will be covered in the cost principle section FAR 31.205-xx. Costs for voluntary VECPs are allowable costs if an advance agreement is entered into between the profit center and the local contracting officer.

6. Savings Sharing Arrangements

The Government/Contractor sharing arrangement will be changed from a 50%/50% share to a 65%/35% share.

DoD VE SUBCOMMITTEE WRITES LANGUAGE

VE Subcommittee took the recommendations from the Cost Accounting Subcommittee and wrote the language in accordance with the recommendations. The changes were submitted to the DAR Council who approved the changes on February 1989 and submitted the changes to the Civilian Agency Acquisition Council (CAAC). The CAAC agreed with the DAR Council in April 1989 and, they forwarded the case to the FAR Secretariat for processing as a Federal Register Notice and as a final rule.

The case number was again changed to 89-10. But, before it was published DCAA again blocked the change and the DAR Council put it on hold until the issues were resolved.

DoD DIRECTOR OF DEFENSE PROCUREMENT STEPS IN

After this block, the DAR Council decided to drop the case and sent a letter to Ms. Eleanor Spector, the Director of Defense Procurement. After she received the letter, she instructed the DAR Council to reinstitute the case-make it simple and get it published in the Federal Register. The DAR Council meet, sent the case back to the Cost Accounting Subcommittee for rewording to satisfy DCAA's latest concerns. The subcommittee reworded the change and the DAR Council again approved the "new" wording and the case was sent to the Civilian Agency Acquisition Council for review and approval. The Civilian Council approved the "new" wording and returned the case for publication.

PROPOSED NEW LANGUAGE

The new proposed language for FAR 48.101 is:

48.101 GENERAL

(A) NO CHANGE

(B) THERE ARE TWO VALUE ENGINEERING APPROACHES:

(1) THE FIRST IS AN INCENTIVE APPROACH IN WHICH CONTRACTOR PARTICIPATION IS VOLUNTARY AND THE CONTRACTOR USES ITS OWN RESOURCES TO DEVELOP AND SUBMIT ANY VE CHANGE PROPOSALS (VECP'S). ~~THE CONTRACT~~ [THIS APPROACH] PROVIDES FOR SHARING OF SAVINGS [WHEN A VECP IS ACCEPTED.] ~~AND FOR PAYMENT OF THE CONTRACTORS' ALLOWABLE DEVELOPMENT AND IMPLEMENTATION COSTS ONLY IF A VECP IS ACCEPTED.~~ [THE ALLOWABILITY OF CONTRACTOR'S DEVELOPMENT AND IMPLEMENTATION COSTS WILL BE DETERMINED IN ACCORDANCE WITH FAR PART 31.] ~~THIS VOLUNTARY APPROACH SHOULD NOT IN ITSELF INCREASE COSTS TO THE GOVERNMENT.~~

(2). NO CHANGE

PUBLISHED IN THE FEDERAL REGISTER

In December 1989, the DAR Council released the hold, gave it yet another case number (89-88) and instructed the FAR Secretariat to publish the case in the Federal Register, to go out as Federal Acquisition Circular 90-05. The case was published in the Federal Register Volume 55, No. 3 on, January 4, 1990, under Proposed Rules page 416 as 48 CFR Part 48.

DIRECTOR OF DCAA BLOCKS FINAL RULE

Right after publication, the Director of DCAA sent another letter to Ms. Spector asking that the notice be removed. DCAA claims that Cost Accounting Standard (CAS) 402 prohibits the allocation of VE development costs on both a direct and indirect basis. Therefore, the proposed FAR change which provides for such a treatment is in noncompliance with this standard.

DCAA feels that "if value engineering change proposals are accepted, the costs of development and implementation of the VECPs will be charged directly to the contract. However, if the VECPs are not accepted, then those costs will be charged as indirect expenses if otherwise allowable. It is DCAA's opinion that this accounting treatment represents a CAS 402 noncompliance, i.e., Charging both direct and indirect costs incurred for the same purpose, in like circumstances. Since contractors do not know at the time of proposal development if the VECP will be accepted, it would not seem possible for the purpose or circumstances for the incurrence of VECP costs to differ based upon its success or failure."

PART 30-COST ACCOUNTING STANDARDS

30.402-20 PURPOSE.

"The purpose of this standard is to require that each type of cost is allocated only once and on only one basis to any contract or other cost objective. The criteria for determining the allocation of costs to a product, contract or other cost objective should be the same for all similar objectives. Adherence to these cost accounting concepts is necessary to guard against the overcharging of some cost objectives and to prevent double counting. Double counting occurs most commonly when cost items are allocated directly to a cost objective without eliminating like cost items from indirect cost pools which are allocated to that cost objective."

30.402-40 FUNDAMENTAL REQUIREMENT

"All costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only with respect to final cost objectives. No final cost objective shall have allocated to it as an indirect cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included as a direct cost of that or any other final cost objective. Further, no final cost objective shall have allocated to it as a direct cost any cost, if other costs have been 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."

OVERCOMING THE DCAA ROADBLOCK

By June of 1991, the Electronics Industries Association, CAS experts, cost principle experts as well as many member corporations sent technical letters of rebuttal to Ms. Spector. These responses are in total disagreement with DCAA's interpretation of the CAS. It is my opinion that the proposed revision to the FAR is fully compliant with CAS 402. WHY ?

THE REBUTTAL

CAS 402 addresses consistent accounting for costs incurred in like circumstances. The VECP contract clause does not dictate the accounting treatment to be accorded the costs of accepted VECPs. It only refers to allowable development and implementation costs as part of the computation of instant contract savings for accepted VECPs. The cost sharing formula does not represent a cost allocation method or accounting practice covered by the CAS rules and regulations. Likewise, the contractor's share of the savings generated is not covered by the CAS rules and regulations. Thus, I would conclude from this

that:

1. There is no CAS consistency problem created by deleting the language in FAR 48.101 (b) (1) and
2. All VECP costs should be treated in accordance with a contractor's approved accounting system and Part 31 of the FAR.

FUTURE

It is very obvious that the DoD statistics, for contractor's participation in the governments VE program, continues to dramatically decline. From FY87 to FY90 program savings for contractors VECPs have declined from \$558 million per year to \$243 million per year.

As this goes to press, the total contractor VE savings for 1991 have not been released. However, all indications point to a 1991 reduction in contractor participation in the Government VE program greater than previous years. We know that during this period, there has been a major reduction in government spending and a tightening of contractors "belts", but the decline in VECP savings is way out of proportion to even these reductions. I think this can be attributed to the increased risk to contractors by the misinterpretations concerning allowability of costs for unaccepted VECPs. If this risk to contractors is alleviated, it will reverse the downward trend in VECP activity. It will come at a time when we all must maximize our savings to help compensate for the declining defense budgets and declining economy. The best way to accomplish this is through the Government VE program by submitting VECPs.

REFERENCES

1. Defense Acquisition Regulation Case 83-68: Allowability of Value Engineering Costs, 1983.
2. Federal Acquisition Regulation Case 85-257, 89-10 & 89-88: Allowability of Value Engineering Costs, 1985-89.
3. Deputy Secretary of Defense memorandum, March 1986
4. Report from the Senate Oversight of Government Management Subcommittee of the Committee of Governmental Affairs, April 1987.
5. Costs Principles Subcommittee recommendations, October 1987.
6. Office of Management and Budget Circular A-131, 26 January 1988
7. Electronic Industries Associations correspondence between 1985-1991.
8. Federal Acquisition Circular 90-05 as published in Federal Register/Vol. 55, No. 3, January 4, 1990
9. Federal Acquisition Regulation Part 48-VALUE ENGINEERING CCH 31,243 pages 19,049-19,075
10. Federal Acquisition Regulation Part 30--COST ACCOUNTING STANDARDS 30.402-20--PURPOSE CCH 30,573 pages 17,864-17,869
30.402-40--FUNDAMENTAL RE- QUIREMENT CCH 30,573.08 page 17,862
11. 40 United States Code (U.S.C.) 486 (C)
12. 10 U.S.C. Chapter 13
13. 42 U.S.C. 473 (c)