The Importance of Recurring + Nonrecurring Costs

Distinguishing between recurring and nonrecurring costs is an important aspect of estimating costs of major defense acquisition programs.

BY JAMES MYERS

About the Author

JAMES MYERS, CPA, MBA, is a certified public accountant for the Institute of Defense Analyses in Alexandria, Virginia. He is a member of the Washington, DC, Chapter of NCMA. Send comments about this article to cm@ncmahq.org.
The Distinction Between Recurring and Nonrecurring Costs is important to acquisition and management professionals for a number of reasons. In general terms, the distinction conveys important information on the frequency with which such costs are incurred—recurring costs are expected to be incurred in a repeating fashion, whereas nonrecurring costs are expected to be incurred only once or only at certain intervals.

Estimating accuracy is normally improved when repetitive costs are estimated separately from the nonrepetitive elements. Costs that have already been incurred and that are not likely to be necessary for the remainder of production should be excluded from the estimated cost for the next unit to be produced. If the recurring and nonrecurring costs are not properly segregated, then the estimate is likely to be over- or understated. For example, cost estimating techniques such as improvement curves (e.g., learning curves) should be applied to costs only after first removing nonrecurring costs, such as those associated with specialized test equipment and pre-production engineering efforts. Collecting cost data separately based on its classification as either recurring or nonrecurring also facilitates estimating by analogy. For instance, suppose a certain missile program required a complement of nonrecurring test activities. Some or all of these activities might apply to a similar missile system development, and having data on the nonrecurring costs associated with these efforts would be useful to estimate this new program.

The benefit provided by the distinction between recurring and nonrecurring cost segregation does not convey merely to cost estimating; rather, it extends to contracting. Costs that are properly classified as recurring or nonrecurring promote a proper understanding of the full impact of Engineering Change Proposals (ECPs). To give those in authority a proper understanding of the scope of configuration changes, ECPs should be broken out between the one-time costs of implementation and the recurring costs of implementing configuration changes in all future units.

Value engineering, which is required by P.L. 104-106 and FAR 48.201, is similarly enhanced by the distinction between recurring and nonrecurring costs. The purpose of a value engineering program is to achieve essential functions at the lowest feasible life-cycle cost. The separation of costs into recurring and nonrecurring categories in a value engineering program allows for the establishment of meaningful unit production cost goals and cost reduction metrics and facilitates cost-as-an-independent-variable (CAIV) trades between alternative approaches. For example, the distinction between recurring and nonrecurring costs enables analysts to determine whether the nonrecurring costs associated with value engineering change efforts are likely to be recouped by the anticipated recurring savings. Potential CAIV trades should be evaluated by examining the costs of alternatives over the life cycle of the system. While it may appear to be wise to avoid investing in certain nonrecurring design activities, the recurring savings associated with operating and supporting the system over its life cycle may warrant the investment.

Contracting officers who award multiyear contracts under the authority provided by 10 U.S.C. §2306b are required by FAR 17.106-3(c) to distinguish between recurring and nonrecurring costs because “the inclusion of recurring costs in cancellation ceilings is an exception to normal contract financing arrangements and requires approval by the agency head.”

If you are now convinced of the importance of segregating costs into recurring and nonrecurring classifications, the next logical question might be “How is this accomplished?” followed by “What guidance is there to make this important distinc-
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Costs are provided in DOD 5000.04-M-1(c) as follows.

Recurring costs: Repetitive elements of development and investment costs that may vary with the quantity being produced during any program phase. Examples of recurring costs include engineering efforts required for redesign, modifications, rework, and replacement; tool maintenance, modification, rework, and replacement; and training.

Nonrecurring costs: Those elements of development and investment costs that generally occur only once in the life cycle of a system. Examples of nonrecurring costs include system test, pre-production activities, basic design and development through the first release of engineering drawings and data, basic tool and production planning through initial release, engineering models built for development or test purposes only, and specialized workforce training.

The Acquisition Approach

The FAR and DFARS govern the acquisition of supplies and services within the DOD. Although there are no formal guidelines for distinguishing between recurring and nonrecurring costs in either set of regulations, the following definitions are provided in FAR 17.103.

Recurring costs: Costs that vary with the quantity being produced, such as labor and materials.

Nonrecurring costs: Those costs that are generally incurred on a one-time basis and include such costs as plant or equipment relocation, plant arrangement, special tooling and special test equipment, preproduction engineering, initial spoilage and rework, and specialized work force training.

Common Misconceptions

At first glance, these definitions do not necessarily conflict; however, different interpretations and common misconceptions in practice often distort the proper classification of recurring or nonrecurring costs. In the following paragraphs, a few of the major misconceptions are explored.

The first misconception is the association of color of money issues with the type of appropriation used. This results in the erroneous assertion that any nonrecurring effort would have to be funded solely with research, development, test, and evaluation (RDT&E) funding, and conversely, any recurring efforts would have to be funded solely with procurement appropriations. In reality, both the RDT&E and procurement appropriations can be used to fund the recurring and nonrecurring activities in development and production efforts, respectively.

The second misconception is the relationship of the product life-cycle phase with a single source of appropriation. Under this interpretation, all activities performed and costs incurred in the development life-cycle phase are inherently nonrecurring, and conversely, all activities performed and costs incurred in the production life-cycle phase are recurring. Again, in reality, there are recurring and nonrecurring activities and costs in both phases. For example, if several production-representative test articles are built in the development phase, the labor, material, and overhead costs associated with building these units would be recurring whereas the design and test activities and costs would be classified as nonrecurring. In production, activities and costs associated with manufacturing products would be classified as recurring whereas the pre-production planning and line set-up activities and costs would be classified as nonrecurring.

These two major misconceptions as well as numerous others result in a tremendous amount of subjectivity and inconsistency in the manner in which cost classifications are made. In practice, contractor accounting and estimating systems are not required to distinguish between recurring and nonrecurring costs and typically do not make the distinction. As a result, the internal practices of each company in classifying costs as recurring or nonrecurring can vary significantly—even in instances of similar commodity classes. For example, an element of cost can be classified as recurring in one aircraft program, but be classified as non-
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recurring on another similar aircraft program. Because of this and due to the lack of uniform policies and procedures, there is a fundamental inconsistency in the classification of recurring and non-recurring costs.

Current Initiatives

There are currently several initiatives underway to help resolve this situation. In the DOD, the CSDR Focus Group, a joint government–industry consortium under the cognizance of the OSD Defense Cost and Resource Center (DCARC), recently performed an in-depth analysis of the definitions of recurring and nonrecurring and included its revised definitions into the CSDR Manual, DOD 5000.04-M-1, and in the CCDR Data Item Descriptions (DIDs). Several options were considered, including:

- **Defining** recurring and nonrecurring costs consistently between the DOD 5000.04-M-1 and the FAR,
- **Requiring** contractors to disclose their policies and procedures for classifying costs as recurring or nonrecurring as part of their annual CAS disclosure statements,
- **Establishing** a post-award conference immediately after contract award in order to consistently establish recurring/nonrecurring cost definitions between the government and the contractor, and
- **Possibly including** a determination as to whether or not a contractor has established adequate policies and procedures to consistently distinguish between recurring and nonrecurring costs as part of the pre-award surveys and determinations of responsibility under FAR Part 9.105-1.

The final changes included in the CSDR Manual and related CCDR DIDs (which currently are being reviewed and coordinated) revised recurring and nonrecurring definitions to include numerous specific examples of the kind of costs that should be assigned to each category. The manual also included the requirement for a government and contractor conference either immediately before or after contract award to resolve CSDR issues, including the proper classification of recurring and nonrecurring costs. The manual further provided overarching guidance that should be considered in this cost classification process. Other efforts include the Space Systems Cost Analysis Group (SSCAG), a consortium of U.S. and NATO allied nation organizations from government and industry, who is updating the detailed definitions of recurring and nonrecurring costs as they apply to space systems.

Conclusion

An important characteristic of cost information is whether the costs are recurring or nonrecurring. This important classification has implications for cost analysts as well as contracting officers. However, the distinction between recurring and nonrecurring lacks uniformity and consistency due to the factors outlined earlier, and this deficiency needs to be remedied. CM