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FEATURE COMMENT • DDP's Guidance Paper On Changes In Cost Accounting Practice

On January 17, 2002, the Director, Defense Procurement (DDP) issued guidance to assist administrative Contracting Officers and auditors in determining what events trigger a change in cost accounting practice under the Cost Accounting Standards, including in particular, changed cost allocation practices in connection with organizational changes. (The full text of the guidance is available at <http://www.acq.osd.mil/dp>.) The DDP guidance follows on the heels of an aborted seven-year effort by the Cost Accounting Standards Board to expansively redefine what constitutes a change in cost accounting practice (see 42 GC ¶ 247), and thereby effectively reverse the result in *Perry v. Martin Marietta Corp.*, 47 F.3d 1134 (Fed. Cir. 1995), 14 FPD ¶ 10, 37 GC ¶ 95. See 65 Fed. Reg. 37470 (June 14, 2000). Much like the CAS Board's contentious proposals, the DDP guidance promises to dramatically increase the number of "changes" subject to the cost impact process to include certain pool split-outs, pool combinations, and functional transfers. This will result in increased administrative costs for both the Government and contractors and more disputes regarding cost accounting practice changes.

This FEATURE COMMENT examines a number of issues raised by the DDP guidance, including whether (1) DDP has authority to interpret CAS Board regulations, (2) the guidance paper should have been subject to formal rulemaking procedures, and (3) the guidance is consistent with the CAS Board regulations it purports to interpret.

Scope of DDP Authority—The Department of Defense unquestionably has authority to issue

policy guidance to its contracting personnel. The so-called "housekeeping statute," 5 USC § 301, authorizes the heads of executive departments to prescribe regulations governing the internal affairs of their departments. In addition, Congress has expressly granted the Secretary of Defense authority, direction, and control over DOD, 10 USC § 113(b), and directed the Under Secretary of Defense for Acquisition, Technology, and Logistics (to whom DDP reports) to establish acquisition policies for all elements of DOD, 10 USC § 133(b).

Whether DDP has authority to issue this cost accounting practice change guidance is a much closer question. The DOD Working Group Items arguably provide some precedent, if not support, for DDP's issuance of the January 2002 guidance paper. From 1976 through 1981, a DOD CAS Steering Committee Working Group published 25 Working Group Items (including one amended item) providing "interim guidance" on various CAS administration and implementation issues. Although the CAS Board did not always agree with the Working Group's interpretations, it was generally acknowledged within the Government contracting community that DOD had authority to issue the Working Group Items. For several reasons, however, the Working Group Items may not be a perfect fit with the new accounting practice change guidance.

The Working Group Items were published during the tenure of the original CAS Board, which was established by the Defense Production Act Amendments of 1970, P.L. 91-379. The original CAS Board was an agent of Congress, independent of the executive branch, and consisted of the Comptroller General as chairman and four other members appointed by the Comptroller General. It had authority to "promulgate cost-accounting standards designed to achieve uniformity and consistency in

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the cost-accounting principles followed by defense contractors and subcontractors under Federal contracts,” and, with some exceptions, the Standards were mandatory for use “by all Federal agencies and by defense contractors and subcontractors.” The original CAS Board also had authority “to make, promulgate, amend, and rescind rules and regulations for the implementation of cost-accounting standards promulgated under subsection (g).”

There was some question whether the Standards, rules and regulations promulgated by the original CAS Board could constitutionally be made binding on federal agencies. In *Boeing Co. v. U.S.*, 680 F.2d 132 (Ct. Cl. 1982), *cert. denied*, 460 U.S. 2082 (1983), 24 GC ¶ 266, the contractor challenged the constitutionality of the CAS enabling statute, arguing that only “officers of the United States” appointed in accordance with the “Appointments” clause of the Constitution, Art. II, § 2, cl. 2, could lawfully promulgate cost accounting standards for use on defense contracts. Of the five CAS Board members, only the Comptroller General had been appointed by the President and confirmed by the Senate, and then only in his position as Comptroller General, not as Chairman of the CAS Board. The then-Court of Claims acknowledged that the constitutional issue was “by no means insubstantial,” but ultimately declined to address it, reasoning that even if the CAS statute were invalid, DOD “had the independent authority to accept the standard[s] on its own,” and had done so by incorporating them into the procurement regulations. 680 F.2d at 141. The court went on to explain:

Under the same general authority which grounded adoption of the Armed Services Procurement Regulation, the Defense Department could adopt or accept any permissible cost standard, no matter who the proposer.... Even if the Cost Accounting Standards Act were invalid, the law would still not limit the sources from which the Defense Department could find and pick its cost accounting standards—so long as those standards were substantially proper (as we have held *supra*).

Id. (footnote omitted).

Before DOD could assume the CAS Board’s functions, the current CAS Board was established by § 26 of the Office of Federal Procurement Policy Act Amendments of 1988, P.L. 100-679. The current CAS Board is chaired by the Administrator

of OFPP, who, as Administrator, is “authorized and directed, pursuant to the authority conferred by Public Law 93-400 and subject to the procedures set forth in such Public Law, to promulgate a single, simplified, uniform Federal procurement regulation and to establish procedures for insuring compliance with such provisions by all Federal agencies.” 41 USC § 405a. In contrast to the original CAS Board’s enabling statute, the current CAS Board has “the *exclusive authority* to make, promulgate, amend, and rescind cost accounting standards and interpretations thereof designed to achieve uniformity and consistency in the cost accounting standards governing the measurement, assignment, and allocation of costs to contracts with the United States.” 41 USC § 422(f) (emphasis added). The CAS Board also has the authority to “promulgate rules and regulations for the implementation of cost accounting standards promulgated or interpreted under subsection (f).” 41 USC § 422(h)(1). Although this latter grant of authority is not exclusive, 41 USC § 422(j) requires the Administrator to “ensure that no regulation or proposed regulation of an executive agency is inconsistent with a cost accounting standard promulgated or amended under this section by rescinding or denying the promulgation of any such inconsistent regulation or proposed regulation and taking such other action [under 41 USC § 405] as may be appropriate.” The statute further provides that “[c]osts which are the subject of cost accounting standards promulgated under this section shall not be subject to regulations that are established by another executive agency that differ from such standards with respect to the measurement, assignment, and allocation of such costs.” 41 USC § 422(j)(4).

Hence, unlike the statutory regime in effect when DOD published the CAS Working Group Items, the current CAS Board’s enabling statute expressly precludes federal agencies from promulgating interpretations of the CAS or regulations inconsistent with the CAS. Accordingly, to the extent the DDP guidance does either of those two things, it is contrary to the OFPP Act.

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Rulemaking Procedures—Another significant issue raised by the DDP guidance is the process by which it was published. In marked contrast to the transparency of the earlier CAS Board rulemaking process on cost accounting practice changes, which included a number of public hearings and the publication of a staff discussion paper (35 GC ¶ 256), an advance notice of proposal rulemaking (37 GC ¶ 236), a notice of proposed rulemaking (38 GC ¶ 451), and two supplemental notices of proposed rulemaking (39 GC ¶ 344; 41 GC ¶ 362), the DDP guidance was published without any notice or public comment. In order for regulations to have the force and effect of law, they must be promulgated pursuant to a statutory grant of authority and in compliance with any required rulemaking procedures. *Chevron Corp. v. Brown*, 441 U.S. 281, 302-03 (1979).

The Administrative Procedure Act (APA) requires that substantive rules be promulgated in accordance with notice-and-comment rulemaking procedures. 5 USC § 553. Similarly, the OFPP Act requires that notice-and-comment rulemaking procedures be followed before issuing any procurement policy or regulation that will have either a significant effect beyond the internal operating procedures of the issuing agency or a significant cost or administrative impact on contractors. 41 USC § 418b. Finally, the CAS Board's enabling statute prescribes a four-step rulemaking process for promulgating Standards or interpretations thereof. See 41 USC § 422(g). The notice-and-comment requirements are "designed to assure fairness and mature consideration of rules of general application." *NLRB v. Wyman-Gordon Co.*, 394 U.S. 759 (1969). They afford an opportunity for "the agency promulgating the rule to educate itself before establishing rules and procedures which have a substantial impact on those regulated." *Texaco, Inc. v. Federal Power Commn.*, 412 F.2d 740, 744 (3d Cir. 1969). DDP's failure to follow notice-and-comment procedures, if required, would be grounds for invalidating the guidance paper. See *National Org. of Veterans Advocates, Inc. v. Secretary of Veterans Affairs*, 260 F.3d 1365, 1375 (Fed. Cir. 2001).

Interpretive rules, on the other hand, are exempt from the APA notice-and-comment requirements. 5 USC § 553(b)(3)(A). The label attached by the agency is not determinative; rather, one must

look to what the rule in fact does. See, e.g., *Lewis-Mota v. Secretary of Labor*, 469 F.2d 478, 481-82 (2d Cir. 1972). The line between substantive and interpretive rules is often unclear. The Federal Circuit has explained the distinction as follows:

"Substantive rules" [are] those that effect a change in existing law or policy or which affect individual rights and obligations.... "An interpretive statement simply indicates an agency's reading of a statute or rule. It does not intend to create new rights or duties, but only reminds affected parties of existing duties."

National Org. of Veterans Advocates, 260 F.3d at 1375 (citations omitted). Importantly, interpretive rules do not have the force and effect of law, and are therefore not binding on contractors or the courts. *Chevron*, 441 U.S. at 313-14. Thus, for example, the Defense Contract Audit Agency Contract Audit Manual (CAM), which is published without notice-and-comment procedures, instructs DCAA auditors to avoid citing the CAM in audit reports or correspondence outside the agency. CAM ¶ 0-002.a (Jan. 2002). Interpretive rules are also not entitled to the "*Chevron*-style deference" normally accorded an agency interpretation of a statute it administers. *Christensen v. Harris County*, 529 U.S. 576, 587 (2000). Moreover, a rule interpreting an agency regulation is not entitled to any deference unless the regulation is ambiguous. 529 U.S. at 588. Otherwise, the Supreme Court has observed, "the agency, under the guise of interpreting a regulation, [could] create de facto a new regulation." *Id.* DOD's interpretation of the CAS Board regulations would not, in any event, be entitled to any deference because the CAS regulations are not DOD regulations. *Martin Marietta*, 47 F.3d at 1137.

What constitutes a "cost accounting practice" and a "change in cost accounting practice" can have a significant cost and administrative impact on contractors. The "Cost Accounting Standards" clause requires the contractor to follow consistently its disclosed and established cost accounting practices, and, if any change in those practices is made, to apply the change pro-

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spectively and amend its Disclosure Statement accordingly. Federal Acquisition Regulation 52.230-2(a)(2); 48 CFR § 9903.201-4(a)(2). Paragraph (a)(4) of the “CAS” clause requires the contractor to “[n]egotiate with the Contracting Officer to determine the terms and conditions under which a change may be made to a cost accounting practice,” with the proviso that the agreement cannot result in increased costs paid by the United States unless the CO has determined, in accordance with § 9903.201-6(c)(1), that the change is desirable and not detrimental to the interests of the Government. *Id.* Paragraph (a)(5) requires the contractor to “[a]gree to an adjustment of contract price or cost allowance, as appropriate, if the Contractor or a subcontractor fails...to follow any cost accounting practice consistently and such failure results in any increased costs paid by the United States.” *Id.* If a contractor desires to make a change in its cost accounting practices or is determined to have failed to follow consistently its disclosed and established practices, it is required by the “Administration of Cost Accounting Standards” clause to submit a cost impact proposal, identifying the impact of the change or noncompliance on each CAS-covered contract. FAR 52.230-6. Thus, putting aside the question of whether DDP has the authority to interpret CAS Board regulations, to the extent the guidance paper is inconsistent with those regulations (as they have been interpreted by the agency boards of contract appeals and the courts), it will plainly have a significant effect beyond the internal operating procedures of DOD and a significant cost and administrative impact on contractors. See 41 USC § 418b. Unlike the CAM, which contractors and COs are free to ignore, DOD contracting personnel are likely to view the DDP guidance as mandatory.

Hence, by expanding the circumstances that constitute a change in cost accounting practice, the DDP guidance has created de facto a new regulation.

DDP’s Expansive and Erroneous Definition of “Change in Cost Accounting Practice”—The DDP guidance begins innocuously enough by observing that organizational changes are not, by themselves, cost accounting practice changes, and “[i]n determining whether a cost accounting prac-

tice change has occurred, the administrative contracting officer and auditor should focus on whether accounting methods or techniques have changed as part of the organizational change.” Both observations are consistent with Preamble J to the CAS Board regulations and the Federal Circuit’s holding in *Martin Marietta*, 47 F.3d at 1139. Consistent with the CAS Board’s definition at 48 CFR § 9903.302-2, the guidance paper also correctly notes that none of the following are changes in cost accounting practice:

- The initial adoption of a cost accounting practice the first time a cost is incurred or a function is created;
- The partial or total elimination of a cost or cost of a function; or
- The transfer of contract work from one segment to another, provided the cost accounting practices at the segments remain unchanged.

These principles are important because they limit the universe of cost accounting practice changes. However, while the guidance paper correctly states the principles, it effectively negates them with its illustrations and expansive new definition of changes in cost *allocation* practices.

The CAS Board regulations define the term “cost accounting practice” as “any disclosed or established accounting method or technique which is used for allocation of cost to cost objectives, assignment of cost to cost accounting periods, or measurement of cost.” 48 CFR § 9903.302-1. A “change to a cost accounting practice” is defined to mean any alteration in a cost accounting practice, as defined in 9903.302-1. 48 CFR § 9903.302-2. The term “measurement of cost” means the “accounting methods and techniques used in defining the components of cost, determining the basis for cost measurement, and establishing criteria for use of alternative cost measurement techniques.” 48 CFR § 9903.302-1(a). “Assignment of cost to a cost accounting period” means the “method or technique used in determining the amount of cost to be assigned to individual cost accounting periods.” 48 CFR § 9903.302-1(b). And the term “allocation of cost to cost objectives” is defined as follows:

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Allocation of cost to cost objectives, as used in this part, includes both direct and indirect allocation of cost. Examples of cost accounting practices involving allocation of cost to cost objectives are the accounting methods or techniques used to accumulate cost, to determine whether a cost is to be directly or indirectly allocated, to determine the composition of cost pools, and to determine the selection and composition of the appropriate allocation base.

48 CFR § 9903.302-1(c).

Changes in Composition of Cost Pool or Base:

The guidance paper expands the CAS Board's definition of "allocation of cost to cost objectives" by creating a new category of so-called "changes in cost accumulation practices," which, according to the guidance paper, "generally occur when there is a change in the composition of the cost pool and/or cost allocation base." The guidance paper illustrates this new concept with examples of indirect cost pool combinations, pool split-outs, and transfers of functions between pools reminiscent of the proposals abandoned by the CAS Board. According to the DDP guidance, a change in cost accounting practice occurs whenever, as a result of combining or dividing indirect cost pools, or transferring functions between them, there is a change in the composition of functions and activities included in the pool or pools.

For example, in an illustration on pages 4–5 of the guidance paper, Segment A of Company 1 has an assembly overhead pool that includes assembly supervision, materials inspection, and machine maintenance. Company 1 acquires Company 2 and establishes it as Company 1's new Segment B. The functions and activities in Segment B's fabrication pool are fabrication supervision and tool calibration. Company 1 then merges Segment B's fabrication pool with Segment A's assembly overhead pool (presumably by merging the two segments or transferring all of the affected functions and activities from one segment to the other since segments do not share indirect cost pools). There is no indication that the pool combination results in any change in the allocation base or the method or technique for allocating costs to final cost objectives. Nevertheless, the illustration concludes that there has been a change in pool composition—and, therefore, a change in cost accounting prac-

tice—for both Segment B and Segment A because the functions and activities in the combined pool are not generally the same as the functions and activities of the previously separate pools.

In another illustration on page 6 of the guidance paper, an engineering testing function is entirely eliminated from an indirect cost pool of Segment K and transferred to an indirect cost pool of Segment L, which did not previously contain an engineering testing function. The illustration concludes that the transfer results in a change in pool composition—and, therefore, a change in cost accounting practice—for both Segment K and Segment L (because Segment K's indirect cost pool no longer contains an engineering testing function and Segment L's indirect cost pool contains a function it did not contain before).

Both of these illustrations are directly contrary to the holding in *Martin Marietta* and conflict with the CAS Board's illustration of what constitutes a change at 48 CFR § 9903.302-3(c)(3). *Martin Marietta* involved an internal corporate reorganization that included the regrouping of various indirect cost pools and the transfer of a management function from a home office to a newly created intermediate home office, all of which increased the amount of costs allocated to a Federal Aviation Administration contract. Both the Armed Services Board of Contract Appeals and the Federal Circuit expressly rejected the Government's argument that mere changes to the size and composition of indirect cost pools and allocation bases constituted changes to cost accounting practices.

Interestingly, the ASBCA opinion in *Martin Marietta* notes that in 1977, during the first CAS Board's consideration of regulations defining a change in cost accounting practice, DCAA unsuccessfully urged the adoption of an illustration showing the merger of two segments that continued to use the same pool and allocation base as they used before the merger. The CAS Board rejected that suggestion because the illustrated events did not constitute an accounting change. The Board included instead the illustration now found at 48 CFR

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§ 9903.302-3(c)(3). In that illustration, a contractor merges two operating segments that use different cost accounting practices to allocate manufacturing costs. Specifically, Segment A allocates the costs using a direct labor hour base, and Segment B uses a direct labor dollar base. Because the merged segment allocates its manufacturing overhead costs using a direct labor dollar base (i.e., the base previously used by Segment B), the illustration concludes that there is a change in cost accounting practice for Segment A. Hence, the ASBCA concluded, “the only identified change in practice was the change in the proportional allocation method and *not* the changes in the sizes of the pool or base.” *Martin Marietta Corp.*, ASBCA 38920 et al., 92-3 BCA ¶ 25175 (emphasis added), 34 GC ¶ 733.

Similarly relying on the illustration at 48 CFR § 9903.302-3(c)(3), the Federal Circuit agreed with the ASBCA, holding that:

the fact that the size and composition of the overhead cost pool and segment base are changed as a result of the merger would not be treated as a change in a cost accounting practice. Only if there were a change in the methodology of how costs are accumulated in the overhead pool or allocated to segments would the CASB illustration result in a change in a cost accounting practice.

47 F.3d at 1138. Notably, the Federal Circuit also rejected the Government’s argument that the illustration now found at 48 CFR § 9903.302-3(c)(1) “support[ed] its position that any change in the size or composition of cost pools or the grouping of segments is a change in accounting practices.” *Id.* In that illustration, an operating segment that allocates its general and administrative expense pool using a total cost input base takes on a significant amount of new work requiring only insignificant quantities of materials. As a result, the segment changes its G&A allocation base from a total-cost-input base to a value-added base. The Government in *Martin Marietta* argued that this illustration “involved a change in the selection and composition of the base, which resulted in a change to a cost accounting practice.” 47 F.3d at 1139 (emphasis added). The Federal Circuit unequivocally disagreed, stating that:

While we agree there was a change in a cost accounting practice, as we read the illustration the change was one in *allocation methodology*,

from a total cost input base to a value added base. This is entirely consistent with the interpretation by the board based on the illustration at [§ 9903.302-3(c)(3)] that *a change in accounting practice refers to changes in allocation methodology rather than to a change in the composition and size of cost pools and grouping of segments.*

Id. (emphasis added; footnote omitted). Thus, both the CAS Board in 1977 and the Federal Circuit in *Martin Marietta* expressly considered and rejected the view—now improperly advanced in the new DDP guidance—that a change in the composition of a cost pool and/or cost allocation base constitutes a change in cost accounting practice.

First-Time Adoption or Elimination of Practice: The Segment K illustration on page 6 of the DDP guidance paper also conflicts with 48 CFR § 9903.302-2(a), which specifically excludes from the definition of an accounting change (1) “[t]he initial adoption of a cost accounting practice for the first time a cost is incurred, or a function is created,” and (2) “[t]he partial or total elimination of a cost or the cost of a function.” In the illustration, Segment K no longer requires an engineering testing function and eliminates the cost of providing it. Segment L, on the other hand, requires an engineering testing function for the first time, and adopts a cost accounting practice for allocating the costs of it. In failing to treat this illustration as the elimination and initial adoption of cost accounting practices (neither of which triggers a cost accounting practice change under the CAS Board’s regulations, see 48 CFR § 9903.302-2(a)), the guidance paper erroneously considers the entire company as the relevant accounting entity for purposes of determining whether there has been a change in cost accounting practice. Cost accounting practices are defined at the business unit and segment level, not by the company as a whole. For that reason, business units, segments, and home offices are each required to submit separate Disclosure Statements describing their individual cost accounting practices. 48 CFR § 9903.202-1.

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DDP's failure to grasp this fundamental concept is similarly apparent in the payroll illustration on page 4 of the guidance paper. Payroll is a service function typically included in a contractor's G&A expense pool and allocated to final cost objectives using one of the cost input bases permitted by CAS 410. In the illustration, the payroll function previously performed at Segments A and B is now performed at the home office level. There is no indication that as a result of reassigning the payroll function to the home office, either segment changes its method of allocating payroll costs to its final cost objectives. In other words, the costs are still collected in the segments' respective G&A pools and allocated to their final cost objectives using the same cost input base, regardless of where the function is performed, i.e., at the segment, the home office, or even outsourced to a third party. Thus, there is nothing to suggest that the cost accounting practices of either segment have changed. Curiously, however, the illustration concludes that there is a change in cost accounting practice "if the home office *indirectly allocates* the costs of payroll function to Segments A and B," but not "if the home office *directly identifies* the costs of the payroll function to Segments A and B" (emphasis added).

In addition to failing to recognize the segment as the relevant accounting entity, the guidance paper seems to confuse the concept of "direct costs" and "indirect costs" with the CAS 403 concept of "directly allocating" costs to a segment. CAS 402 defines a "direct cost" as "any cost which is identified specifically with a particular final cost objective," and an "indirect cost" as "any cost not identified with a single final cost objective, but identified with two or more final cost objectives or with at least one intermediate cost objective." 48 CFR § 9904.402(a)(3),(a)(5). It is a fundamental requirement of CAS 402 that "[a]ll costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only with respect to final cost objectives." 48 CFR § 9904.402-40. Part III of the CAS Disclosure Statement (CASB-DS-1) requires the contractor to set forth its cost accounting practices for distinguishing between direct and indirect costs. The illustrations in CAS 402 make clear that a change in the treatment of costs incurred for the same purpose in like circumstances

is a change in cost accounting practice. 48 CFR § 9904.402-60(a)(1), (a)(2). However, that is a different concept entirely from CAS 403's requirement that home office expenses "be allocated directly to segments to the maximum extent practical" and expenses not so allocated be grouped in homogeneous expense pools and allocated in accordance with criteria specified in the Standard. It is irrelevant to a segment's cost accounting practices whether the home office allocations the segment receives are allocated directly or indirectly from the home office. What matters are the *methods* or *techniques* the segment uses to allocate those costs, once received, to its final cost objectives.

Conclusion—In summary, the DDP guidance paper expands the definition of what constitutes a change in cost accounting practice, which will impose a significant administrative burden on both the Government and contractors and may well discourage contractors from making beneficial organizational changes. Moreover, because the guidance conflicts in significant respects with the CAS Board regulations as well as the Federal Circuit's holding in *Martin Marietta*, it is likely to generate disputes and litigation. For both of these reasons, the guidance paper is inimical to the Government's attempts to streamline the acquisition process.



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