

Cost-Plus Contract Management

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Your Instructor

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Introduction – What is a Cost-Reimbursement Contract?

- A Cost-Reimbursement Contract provides for payment to the contractor of allowable incurred costs to the extent provided in the contract
 - Unlike a Firm-Fixed-Price (FFP) Contract, most of the cost risk is borne by Government
 - Federal Acquisition Regulation (FAR) 52.232-20 Limitation of Cost
 - Government not obligated to reimburse contractor for costs incurred above estimated cost in Schedule, but neither is contractor obligated to incur costs above estimated cost in Schedule absent an increase of estimated cost from the Contracting Officer
- When used (FAR 16.301-2):
 - (1) Circumstances do not allow agency to define its requirements sufficiently to allow for FFP contract, or
 - (2) Uncertainties involved in contract performance do not permit costs to be estimated with sufficient accuracy to use any type of FFP contract

Introduction – Types of Cost-Plus Contracts

- **Cost-plus-incentive-fee**

- Provides for an initially negotiated fee to be adjusted later by a formula based on the relationship of total allowable costs to total target costs (FAR 16.304)

- **Cost-plus-award-fee**

- Provides for a fee consisting of (a) a base amount (which may be zero) fixed at inception of contract and (b) an award amount, based upon a judgmental evaluation by Government, sufficient to provide motivation for excellence in contract performance (FAR 16.305)

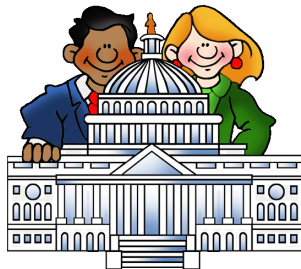
- **Cost-plus-fixed-fee**

- Provides for payment to contractor of a negotiated fee that is fixed at inception of contract (FAR 16.306)

- **BUT NEVER cost-plus-a-percentage-of-cost (FAR 16.102)**

Major Government Players in the Cost-Plus World

- **Procuring Contracting Officer (PCO)**
 - Creates and publicizes solicitations, determines whether certified cost or pricing data must be submitted, selects sources, negotiates and executes contracts and certain modifications, and settles certain defective pricing and direct cost issues
- **Administrative Contracting Officer (ACO)**
 - Performs contract administration functions involving, among other things, forward pricing rate agreements, advance agreements, allowable costs, disputes, progress payments, and cost overruns.
- **Defense Contract Audit Agency (DCAA)**
 - Performs all contract auditing for Department of Defense (DOD) and provides DOD activities with accounting and financial advisory services in connection with negotiating, administering, and settling contracts and subcontracts



Accounting Systems – Basic Requirements

- A cost-reimbursement contract may be used only when the contractor's accounting system is adequate for determining costs applicable to the contract or order (FAR 16.301-3)
- A contractor is responsible for accounting for costs appropriately and for maintaining records, including supporting documentation, adequate to demonstrate that costs claimed have been incurred, are allocable to the contract, and comply with applicable cost principles (FAR 31.201-2)
 - Government may disallow all or part of a claimed cost that is inadequately supported

Accounting Systems – Accounting for Unallowable Costs

- Pursuant to FAR 31.201-6 and Cost Accounting Standard (CAS) 405, contractors must identify and exclude from any billing, claim, or proposal costs that are expressly unallowable or mutually agreed to be unallowable, including costs mutually agreed to be unallowable directly associated costs
 - **Expressly unallowable cost**
 - A particular item or type of cost which, under the express provisions of an applicable law, regulation, or contract, is specifically named and stated to be unallowable
 - **Directly associated cost**
 - Any cost which is generated solely as a result of the incurrence of another cost, and which would not have been incurred had the other cost not been incurred
- Inclusion of expressly unallowable indirect costs in final indirect cost proposals for contracts in excess of \$800,000 subjects contractor to a penalty equal to the amount of the disallowed costs allocated to contracts plus interest on the paid portion, if any, of the disallowance (FAR 42.709-2)
 - Penalty doubles if indirect cost was determined to be unallowable before proposal submission
 - Penalties may be assessed regardless of whether Government reimbursed costs

Accounting Systems – Form

- Defense Federal Acquisition Regulation Supplement (DFARS) 252.242-7006 requires Accounting System to comply with 18 system criteria to be considered an “acceptable accounting system,” including –
 - A sound internal control environment, accounting framework, and organizational structure
 - Proper segregation of direct costs from indirect costs
 - Identification and accumulation of direct costs by contract
- DFARS 252.242-7004, applicable to contractors with non-commercial item cost-reimbursement contracts exceeding \$250,000, requires Material Management and Accounting System (MMAS) to generally comply with 10 system criteria to be considered an “acceptable MMAS,” including –
 - Having an adequate system description including policies, procedures, and operating instructions that comply with the FAR and the DFARS
 - Providing audit trails and maintaining records necessary to evaluate system logic and to verify through transaction testing that the system is operating as desired
 - Establishing and maintaining adequate levels of record accuracy and including reconciliation of recorded inventory quantities to physical inventory by part number on a periodic basis
- DCAA Contract Audit Manual (DCAM) Chapter 5 contains additional guidance on what an accounting system should provide

Audit Process – Record Retention

- Contractor shall maintain and Contracting Officer, or an authorized representative thereof, shall have right to examine and audit all records and other evidence sufficient to reflect properly all costs claimed to have been incurred or anticipated to be incurred directly or indirectly in performance of contract (FAR 52.215-2)
- Generally, contractor is required to retain and make available records for 3 years after final payment (FAR 4.703)
 - FAR 4.705-1 provides other periods of retention that apply to specific records (for example, 4 years for certain accounting records such as accounts receivable invoices and accounts payable records)



Audit Process – Types of Audits and the Audit Report

- **Common Types of Audits:**

- **Accounting System Audit:** Evaluation of contractor's internal controls and assessment of control risk that occurs on a cyclical basis (every 2-4 years) (DCAM Chapter 5)
- **Incurred Costs Audit:** Examination of contractor's cost representations, in whatever form they may be presented (such as interim and final public vouchers, progress payments, incurred cost proposals, termination claims and final overhead claims) to determine whether such incurred costs are reasonable, applicable to the contract, determined under generally accepted accounting principles (GAAP) and CAS applicable to the circumstances, and not prohibited by contract, statute, regulation, or previous agreement with, or decision of, the Contracting Officer (DCAM Chapter 6)
- **Audit of Cost Estimates and Price Proposals:** Evaluation of estimates of cost and profit supporting price proposals submitted by contractor in connection with award, administration, modification, or repricing of Government contracts (DCAM Chapter 9)
- **Audit Report:** The principal means of conveying DCAA's audit results to Contracting Officers and other interested parties (DCAM 10-102)
 - Although only advisory, Contracting Officers typically rely heavily upon DCAA audit reports when deciding cost and pricing issues

“An auditor is a man who watches the battle from the safety of the hills and then comes down to bayonet the wounded.”

Sir Charles Lyell, 1797-1875, *American Accountant*



Disallowance Process

- **FAR 52.242-1 Notice of Intent to Disallow Costs:** Contracting Officer may at any time issue to contractor a written notice of intent to disallow specified costs incurred or planned for incurrence that have been determined not to be allowable
 - Upon receipt, contractor may submit a written response within 60 days to Contracting Officer, with justification for allowance of the costs
 - If contractor submits written response, Contracting Officer shall within 60 days make a written withdrawal of the notice or issue a written decision
 - Failure to issue Notice of Intent does not affect Government's right to take exception to incurred costs
- **Disallowance of Costs after Incurrence:** If examination of a voucher raises a question regarding allowability, an authorized auditor may issue a notice of contract costs suspended and/or disapproved for deduction from current payments with respect to costs claimed but not considered reimbursable (FAR 42.803)
 - For DOD contracts, notice is contained on DCAA Form 1 (DFARS 242.803)
 - If contractor disagrees with deduction, contractor may:
 - (1) Submit a written request to Contracting Officer to consider whether unreimbursed costs should be paid and to discuss findings with contractor;
 - (2) File a claim under the Disputes clause; or
 - (3) Do both of the above

Allowability – Definition

- A cost is allowable only if it complies with the following 5 requirements (FAR 31.201-2):
 1. Reasonableness;
 2. Allocability;
 3. The CAS, if applicable, GAAP and practices appropriate to the circumstances;
 4. Terms of the contract; and
 5. Any limitations set forth in the Cost Principles
- FAR Subpart 31.205 contains Cost Principles for 46 selected items of cost
 - BUT absence of a Cost Principle for a particular item does not imply that the cost is either allowable or unallowable
 - Under FAR 31.204, in absence of a specific Cost Principle, determination of allowability shall be based on principles and standards in the Cost Principles and “the treatment of similar or related selected items”

Allowability – Selected Cost Principles

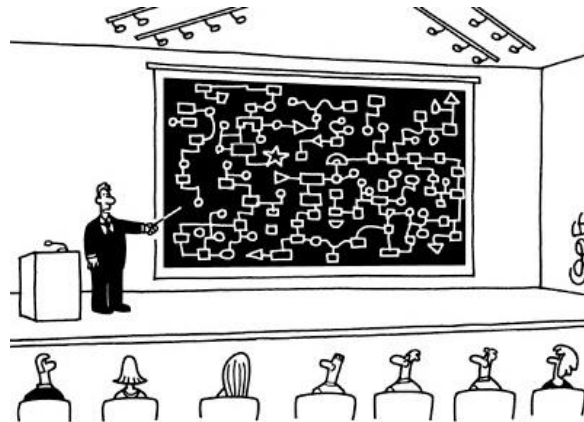
- **Costs of Alcoholic Beverages: Unallowable** (FAR 31.205-51)
- **Entertainment Costs: Unallowable** (FAR 31.205-14)
 - Include costs of amusement, diversions, social activities, and any directly associated costs such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities
- **Employee Morale, Health, Welfare, Food Service, and Dormitory Costs and Credits: Allowable**, subject to limitations (FAR 31.205-13)
 - Costs must have been incurred to improve working conditions, employer-employee relations, employee morale, or employee performance
 - Costs of gifts are **unallowable** (excluding awards for performance or awards made in recognition of employee achievements pursuant to an established plan or policy)
 - Losses from operating food and dormitory services are only **allowable** if contractor's objective is to operate such services on a break-even basis, or if contractor can show unusual circumstances (for example, food and lodging required at remote locations)

Allowability – Selected Cost Principles cont'd

- **Compensation for Personal Services:** **Allowable**, subject to limitations (FAR 31.205-6)
 - Must be for work performed in the current year, reasonable for the work performed and based upon and conform to terms and conditions of contractor's established compensation plan or practice
 - For owners and persons contractually committed to acquire a substantial financial interest in contractor's enterprise, must not be a distribution of profits
 - **Bonus or Incentive Compensation:** Must be paid or accrued under an agreement entered into in good faith between contractor and employees before services are rendered or pursuant to contractor's established plan or policy
 - **Back Pay:** **Unallowable** except in limited circumstances (for example, if required by negotiated settlement, order, or court decree)
 - **Severance:** **Allowable** to extent required by law, employer-employee agreement, established policy, or circumstances of particular employment
 - **Fringe Benefits:** **Allowable** to extent required by law, employer-employee agreement, or established policy
 - **Pension Costs:** **Allowable** if paid pursuant to agreement entered into in good faith between contractor and employees before work or services are performed and to terms and conditions of established plan
 - **Postretirement Benefits:** **Allowable** if incurred pursuant to law, employer-employee agreement, or established policy
 - Subject to statutory cap

Allowability – Selected Cost Principles cont'd

- **Economic Planning Costs: Allowable** (FAR 31.205-12)
 - Economic planning costs are costs of general long-range management planning that is concerned with future overall development of contractor's business and that may take into account eventual possibility of economic dislocations or fundamental alterations in those markets in which contractor currently does business
 - DO NOT include "Organization Costs"



"This is our plan for
the next 1,000 years."

Allowability – Selected Cost Principles cont'd

- **Organization Costs: Unallowable** (FAR 31.205-27)
 - Organization costs are costs incurred in connection with:
 - (1) Planning or executing organization or reorganization of corporate structure of business, including mergers and acquisitions;
 - (2) Resisting or planning to resist reorganization of corporate structure of business or change in controlling interest in ownership of business; and
 - (3) Raising capital
 - Include incorporation fees; costs of attorneys, accountants, brokers, promoters and organizers, management consultants and investment counselors; and cost of any change in contractor's financial structure, excluding administrative costs of short-term borrowings for working capital, resulting in alterations in rights and interests of security holders

Allowability – Selected Cost Principles cont'd

- **Interest and Other Financial Costs:** Interest on borrowings, bond discounts, costs of financing and refinancing capital, legal and professional fees paid in connection with preparing prospectuses, and costs of preparing and issuing stock rights are **unallowable** (FAR 31.205-20)
 - Exception: Interest incurred as result of non-payment of state or local taxes at direction or concurrence of Contracting Officer is **allowable** (FAR 31.205-41)



Allowability – Selected Cost Principles cont'd

- **Travel Costs: Allowable**, subject to limitations (FAR 31.205-46)
 - Costs for transportation, lodging, meals, and incidental expenses are generally **allowable** if incurred by contractor personnel on official company business
 - Airfare costs in excess of lowest priced airfare available to contractor during normal business hours are **unallowable** except in limited circumstances (for example, when such accommodations require circuitous routing, require travel during unreasonable hours, or excessively prolong travel)
 - Also applies to costs of travel by contractor-owned, -leased, or -chartered aircraft
 - Costs of contractor-owned or -leased automobiles are **allowable** if reasonable to extent that automobiles are used for company business



Allowability – Selected Cost Principles cont'd

- **Costs Related to Legal or Other Proceedings:** **Allowable**, but subject to limitations (FAR 31.205-47)
 - **Unallowable** legal costs are incurred –
 - When the result is a criminal conviction
 - When the result is a finding of civil liability for fraud or similar misconduct
 - **Allowable** costs are capped at 80% if the contractor prevails in the litigation
 - Settlement costs of actions commenced by the United States that could have resulted in a criminal conviction or a finding of civil liability for fraud or similar misconduct are only **allowable** to the extent specifically provided in the settlement agreement
 - Other **unallowable** legal costs include:
 - Claims and appeals by and against the Government
 - Bid protests
 - Defense of antitrust suits
 - Otherwise, legal costs are **allowable** if they are:
 - (1) Reasonable;
 - (2) Not otherwise recovered from the Government or a third party; and
 - (3) Percentage of costs allowed does not exceed percentage determined to be appropriate (80% cap)

Allocability – Definitions

- Cost is allocable only if it is assignable or chargeable to one or more cost objectives on basis of relative benefits received or other equitable relationship (FAR 31.201-4)
 - Cost is allocable if it:
 - (1) Is incurred specifically for the contract;
 - (2) Benefits both the contract and other work, and can be distributed to them in reasonable proportion to benefits received; or
 - (3) Is necessary to overall operation of business, although direct relationship to any particular cost objective cannot be shown
- **Direct Cost:** Any cost that is identified specifically with a particular final cost objective (FAR 2.101)
- **Indirect Cost:** Any cost not directly identified with a single, final cost objective, but identified with two or more final cost objectives or with at least one intermediate cost objective (FAR 2.101)

Allocability – Cost Accounting Standards

- The Cost Accounting Standards (CAS) are the single most important body of knowledge governing allocation issues, and auditors frequently base allocability opinions on them, even for non-CAS-covered contracts
- CAS apply to all non-exempt negotiated contracts and subcontracts over \$750,000 (\$2 million for contracts and subcontracts entered into after July 1, 2018)
 - Exemption for contracts and subcontracts of less than \$7.5 million, provided that, at time of award, contractor or subcontractor is not performing any CAS-covered contracts or subcontracts valued at \$7.5 million or greater
- Full CAS coverage: All 19 CAS apply
 - Generally applies to negotiated contracts and subcontracts over \$50 million
- Modified CAS coverage: Only CAS 401, CAS 402, CAS 405, and CAS 406 apply
 - Contractor may elect modified coverage if it receives a covered contract of less than \$50 million



Allocability – Allocation of Direct & Indirect Costs

- **Direct Costs:** No final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for same purpose in like circumstances have been included in any indirect cost pool (FAR 31.202)
 - Direct costs of a contract shall be charged directly to that contract, whereas costs specifically identified with other final cost objectives are direct costs of those cost objectives and are not to be charged to that contract
- **Indirect Costs:** For contracts subject to full CAS coverage, allocation of indirect costs is governed by CAS 418
 - CAS 418 requires indirect costs to be grouped into homogenous indirect cost pools (for example, G&A, manufacturing overhead, etc.) that then shall be allocated to bases of benefiting cost objectives (for example, contracts and/or other cost pools) in reasonable proportion to the beneficial or casual relationship of the pooled costs to the cost objectives
 - FAR 31.203 requires a similar allocation of indirect costs for non-CAS-covered and modified-CAS-covered contracts
 - All items properly includable in an indirect cost base shall bear a pro rata share of indirect costs, regardless of the allowability status of those items

Reasonableness

- A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business (FAR 31.201-3)
- If challenged, burden of proof is upon contractor to establish that a cost is reasonable
- Factors used to determine reasonableness:
 1. Whether cost is type of cost generally recognized as ordinary and necessary for conduct of contractor's business or contract performance;
 2. Generally accepted sound business practices, arm's-length bargaining, and laws and regulations;
 3. Contractor's responsibilities to the Government, other customers, owners of the business, employees, and public at large; and
 4. Any significant deviations from contractor's established practices



Truth In Negotiations Act (TINA)

- Contractors must submit certified cost or pricing data on all contract actions exceeding \$750,000 (\$2 million for all contracts entered into after July 1, 2018)
 - **Cost or pricing data:** All facts that, as of date of price agreement, or an agreed upon earlier date that is as close as practicable to date of price agreement, prudent buyers and sellers would reasonably expect to affect price negotiations significantly (FAR 2.101)
 - Contractor must certify, to the best of its knowledge and belief, that the cost or pricing data are accurate, complete, and current as of the date of price agreement (or earlier agreed upon date)
 - Exceptions:
 1. When Contracting Officer determines that prices agreed upon are based upon adequate price competition;
 2. When Contracting Officer determines that prices agreed upon are based on prices set by law or regulation;
 3. When contract action is for commercial items; or
 4. When a waiver has been granted
- For contracts under TINA threshold, certified cost or pricing data is not required, BUT Contracting Officer may request contractor to submit **data other than certified cost or pricing data** to extent necessary to determine fair and reasonable price (FAR 15.403-3)



Questions?

Thank you!

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