



# **Cost Principles, FAR Part 31 and Direct/Indirect Overhead 2023**

**Session 1: Cost Principles Introduction and Application**



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# Agenda

History of FAR

CAS Background

Overview of Part 31

Unallowable Costs

# History of the FAR

# History of the FAR

- The Federal Acquisition Regulation (FAR), is a substantial and complex set of rules governing the federal government's purchasing process.

- The FAR can be traced to the Armed Services Procurement Regulation (ASPR) established in 1947
- The ASPR was renamed the Defense Acquisition Regulation in 1978 (DAR)

Prior to the establishment of the FAR system and the initial publication of the FAR, two primary procurement regulations existed: the Federal Procurement Regulations (FPR) and the Defense Acquisition Regulation (DAR).

- Generally, the FPR applied to civilian agencies and the DAR applied to the Department of Defense (DOD) and its components
- The proliferation of agency procurement regulations was such that, in its 1972 report, the Commission on Government Procurement stated that it had found "a burdensome mass and maze of
- procurement and procurement-related regulations" within the federal government, and "no effective overall system for coordinating, controlling, and standardizing regulations."

# History of the FAR

- FAR was codified in Title 48 of the Code of Federal Regulations (CFR) in 1984 to create a uniform structure for many federal agencies
- FAR is issued and maintained jointly by the Secretary of Defense, Administrator of General Services and the Administrator, National Aeronautics and Space Administration. Procurement Executives in DOD, GSA and NASA are authorized to make revisions
- Its purpose is to ensure purchasing procedures are standard, consistent, and conducted in a fair and impartial manner.

# Guiding Principles

The FAR also articulates guiding principles for the federal acquisition system

- (a) satisfy the customer in terms of cost, quality, and timeliness of the delivered product or service ...;
- (b) minimize administrative operating costs;
- (c) conduct business with integrity, fairness, and openness; and
- (d) fulfill public policy objectives.

# CAS Background

# What led to CAS?

- In the 1960's defense contractors had inconsistent accounting and estimating practices
- Government believed that accounting regulations, both accounting and regulatory, were too flexible with regard to government contract cost accounting
- Defense spending, particularly negotiated (i.e., not competitive), contracts was high and increasing
- Government and industry could not agree on the need for consistency

# What led to CAS?

- Admiral Rickover testified to congress that the lack of standards created a significant burden to contracting officers and auditors
- Congress asked GAO to perform a feasibility study
- GAO ultimately determined that establishing consistent standards for negotiated contracts (and subcontracts) was feasible

# Congress's Response

Congress responded by passing Public Law 91-379

- “The primary objectives of the Cost Accounting Standards Board is to implement PL 91-379 by issuing clearly stated Cost Accounting Standard to achieve (1) an increased degree of uniformity in cost accounting practices among government contractors in like circumstances and (2) consistency in cost accounting practice by individual Government Contractors over a period of time.”
- Applied to negotiated defense prime and subcontracts of \$100,000 or more unless the price was based on catalogue or market price or established by law or regulation
- Allowed the Cost Accounting Standards Board (CASB) to grant additional exemptions
- The CASB’s authority sunsetted on 9/30/1980 but the standards promulgated by the board remained

# Congress: Act II

On 11/17/1988, Congress passed Public Law 100-679

- Reestablished a 5 member CAS Board with representation from government, industry and the Chairman of the OFPP
- Increased the threshold to \$500,000
- Extended CAS coverage to non-defense contracts

# CAS Purpose

- Promotes uniformity
- Facilitates administration, negotiation and close out of contracts
- Allows the government to better compare the proposals of competitors
- Focus on the allocability of costs

# CAS within the FAR

Most CAS requirements are included either in full or in part within FAR PART 31

- CAS 401 – Consistency in Estimating, Accumulating, and Reporting Costs
- CAS 402 – Consistency in Allocating Costs Incurred for the Same Purpose
- CAS 405 – Accounting for Unallowable Costs
- CAS 406 – Cost Accounting Period
- CAS 407 – Use of Standard Costs for Direct Material and Direct Labor
- CAS 408 – Accounting for Compensated Personal Absence
- CAS 409 – Depreciation of Tangible Capital Assets
- CAS 410 – Allocation of Business Unit G&A Expenses to Final Cost Objectives
- CAS 414 – Cost of Money as an Element of the Cost of Facilities Capital
- CAS 415 – Accounting for the Cost of Deferred Compensation
- CAS 416 – Accounting for Insurance Costs.
- CAS 418 – Allocation of Direct and Indirect Costs

Biggest difference is that Full CAS Coverage triggers completion and filing of a Disclosure Statement. Any future changes would require determination of a cost accounting practice change and calculation of a cost impact

# OVERVIEW OF PART 31

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# CAS is irrelevant if you aren't CAS covered?

- TRUE
- FALSE
- Ummm ..... Maybe?

# FAR Part 31 Purpose

- Establish boundaries and parameters regarding allowable costs that can be negotiated and/or claimed under government contracts or subcontracts
- Key Philosophies Embedded in Cost Principles
  - Government does not want to share in costs that it does not cause nor derive a benefit from (“causal and beneficial”)
  - Equitable allocation or identification of costs to government contracts
  - Non-government programs should absorb their share of costs
  - Selected costs in FAR 31.205-XX identified as unallowable are theoretically not created by doing business with government, nor required to sustain contract performance

# Layout & Structure of Part 31

## 31.1 Applicability

31.201 contains general guidance

- Composition of Total Cost
- Determining Allowability
- Determining Reasonableness
- Determining Allocability
- Credits
- Accounting for Unallowable Costs

# Applicability of Part 31

31.000 – Principles & Procedures for the pricing of contracts, subcontracts and modifications wherever cost analysis is performed

31.101 – “the overall objective is to provide that, to the extent practicable, all organizations of similar types doing similar work will follow the same cost principles”

31.102 - Firm fixed price contracts

- Applicable Parts of FAR Part 31 should be used in pricing of FFP contracts and subcontracts where cost analysis is performed or the clauses require the determination or negotiation of costs
- Does NOT mean that there is a requirement to negotiate individual elements of cost
- Contractor may need to show how estimates exclude unallowable costs in sole source negotiations

# Layout & Structure of Part 31

31.202 defines direct costs

31.203 defines indirect costs

31.204 Application of Principles & Procedures

31.205 Individual cost principles

- 52 parts, 6 reserved

# Importance of the Cost Principles

In addition to providing guidance as to specific costs that the government will or will not pay for, Part 31 provides important directional guidance for contractors

- Composition of total cost – sum of the direct and indirect costs allocable to a contract, incurred or to be incurred, plus the cost of money, less applicable credits. Cost can be determined or estimated using any generally accepted method that is equitable **AND** consistently applied

# Applicability of Part 31

## Commercial Organizations

- The cost principles and shall be used in pricing negotiated supply, service, experimental, developmental, and research contracts and contract modifications with commercial organizations whenever cost analysis is performed
- Cost-reimbursement contracts and cost-reimbursement subcontracts under these contracts performed by commercial organizations and
- The cost-reimbursement portion of time-and-materials contracts except when material is priced on a basis other than at cost
- Negotiating indirect cost rates (see [subpart 42.7](#));
- Proposing, negotiating, or determining costs under terminated contracts (see [49.103](#) and [49.113](#));
- Price revision of fixed price incentive contracts (see [16.204](#) and [16.403](#));
- Price redetermination of price redetermination contracts (see [16.205](#) and [16.206](#)); and
- Pricing changes and other contract modifications.

# Allowability

In order for a cost to be allowable it must comply all of these criteria:

- Reasonable
- Allocable
- Standards promulgated by CAS (where applicable) or generally accepted accounting principles (GAAP)
- Terms of the Contract
- Any limitations in subpart 31

Good rule of thumb (but not universally true): take off your contractor hat and put on your taxpayer hat. As a taxpayer, would you approve of the Government reimbursing a contractor for the particular cost in question?

*If the answer is “no,” then the cost is most likely unallowable.*

# Allowability

- Simply incurring a cost does not justify allowability  
It is contractor's responsibility to properly support proposed or billed costs to demonstrate:
  - Costs were incurred
  - Are allocable (causal or beneficial)
  - Comply with cost principles (i.e., reasonable and not unallowable)
- Failure to have adequate documentation may result in disallowance of costs

# Reasonableness

- Considerations when evaluating reasonableness
  - Reasonable in **nature** and **amount**
  - Whether it is the type of cost generally recognized as ordinary and necessary for the conduct of the competitive business;
  - Generally accepted sound business practices, arm's-length bargaining, and Federal and State laws and regulations;
  - The contractor's responsibilities to the Government, other customers, the owners of the business, employees, and the public at large; and
  - Any significant deviations from the contractor's established practices (unless otherwise justified).
- Costs are either reasonable or unreasonable – there is no provision for "more or less reasonable"

# 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."

- Reasonableness of specific costs must be examined with particular care in connection with firms or their separate divisions that may not be subject to effective competitive restraints.
- No presumption of reasonableness shall be attached to the incurrence of costs by a contractor
- If an initial review of the facts results in a challenge of a specific cost by the contracting officer or the contracting officer's representative, **the burden of proof shall be upon the contractor to establish that such cost is reasonable.**

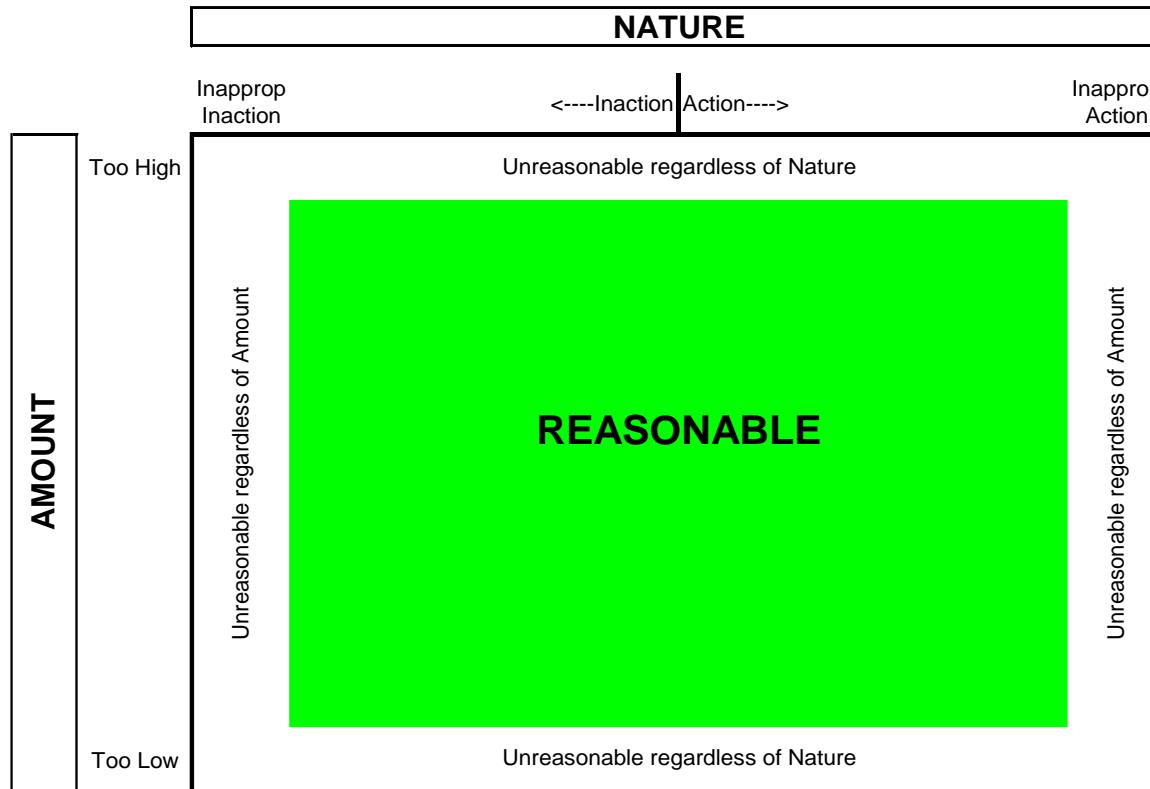
# Allocability

A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship

There must be either a direct or indirect benefit to the contract

- Is incurred specifically for the contract (*But for rule*) (*Direct*)
- Benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received (*Causal/Beneficial relationship*)
- Is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown (*G&A Expenses*)

# Overview of FAR Part 31



# The government must prove that a cost is unreasonable?

- True
- False

# UNALLOWABLE COSTS

# Unallowable Costs

- Costs that are expressly unallowable or mutually agreed to be unallowable, including mutually agreed to be unallowable directly associated costs, shall be identified and ***excluded from any billing, claim, or proposal*** applicable to a Government contract.
- A **directly associated cost** is any cost that is generated solely as a result of incurring another cost, and that would not have been incurred had the other cost not been incurred.
- When an unallowable cost is incurred, its directly associated costs are also unallowable.
- Costs incurred for the same purpose under like circumstances are treated the same as expressly unallowable

# Directly Associated Costs

## “But For” Test

*“But for” the original unallowable transaction/event, the contractor would not have incurred an additional or follow-on expense.*

### Examples:

Travel costs associated with lobbying activities.

Renting a truck to transport materials for a trade show.

Paying incremental fees for Security or Janitorial services for an after-work party.

# Credits

- Contracts must be credited for any portion of income, rebate related to **allowable** costs
- Credit should be reflected as a cost reduction or cash refund

# CAS 405 Definitions

- ***Unallowable cost*** means any cost which, under the provisions of any pertinent law, regulation, or contract, cannot be included in prices, cost reimbursements, or settlements under a Government contract to which it is allocable.
- ***Expressly unallowable cost*** means 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*** means 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.

# Overview of FAR Part 31

## 31.205 – Selected Cost Principles

- 46 separate cost principles covering topics such as advertising, travel, consultants, interest, donations, employee morale, and entertainment
- All 46 cost principles can be logically grouped as follows:



# DCAA Guidance

## DCAA MRD – Audit Alert on *Identifying Expressly Unallowable Costs*

- Enhances the guidance regarding identifying expressly unallowable costs.
- Assist audit teams with making determinations whether specific cost principles identify expressly unallowable costs.
- In order for a cost to be expressly unallowable, the Government must show that it was unreasonable under all the circumstances for a person in the contractor's position to conclude that the costs were allowable.

# DCAA Guidance

## **DCAA MRD – Audit Alert Distributing a Listing of Cost Principles That Identify Expressly Unallowable Costs**

- Distributes a list of cost principles in FAR Part 31 and DFARS Part 231 that meet the definition of expressly unallowable costs.
- If an audit team questions costs based on a cost principle that is on the list, it generally should treat the questioned costs as expressly unallowable and subject to penalties.
- There can be circumstances where an audit team concludes that a cost it is questioning, based on a cost principle that is not included on this list, is expressly unallowable.

# Accounting for Unallowable Costs

Statistical sampling is an acceptable method for identifying unallowable costs:

- Unbiased, valid sample, and sampling technique
- Large dollar or high risk transactions removed from universe and tested separately
- Permits audit verification
- Any items in sample that carry penalties provisions will be projected over universe (e.g., alcohol)
- Advance agreement should be executed for sampling
- Suggest discussing plan with DCAA auditors

# Contractors with Firm Fixed Price contracts do not have to worry about unallowable costs?

- True
- False
- It depends

# QUESTIONS?

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