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

Session 2: The Cost Principles



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Agenda

Recap

Selected Cost Principles

Common Cost Hazards

Best Practices

RECAP

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.

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

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

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

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.

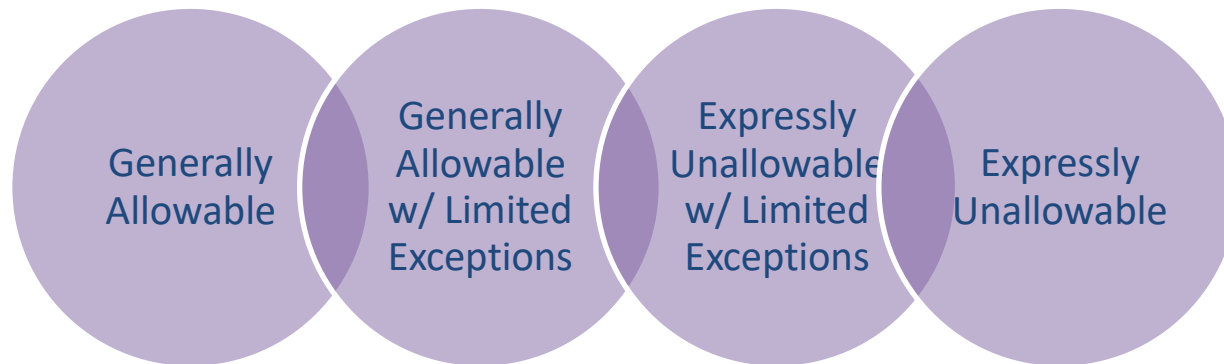
Unallowable Costs

- 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

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:



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*SELECTED COST
PRINCIPLES*

Expressly Unallowable Costs

Certain costs are specified within 31.205 as expressly unallowable

Alcoholic Beverages (31.205-51)

Bad Debts (31.205-3)

Contingency Provisions (31.205-7)

Contributions and Donations (31.205-8)

Entertainment (31.205-14)

Fines and Penalties (31.205-15)

Interest on Borrowed Capital (31.205-20)

Lobbying Costs (31.205-22)

Organization Costs (31.205-27)

Advertising Costs

Allowable

- Recruitment of personnel required for performance of Federal award
- Procurement of goods & services for the performance of the award
- Disposal of scrap or surplus acquired in the performance of award.

Unallowable

- Costs of promotional items, memorabilia, gifts and souvenirs
 - Including recruiting fair giveaways
- Costs of advertising and public relations designed solely to promote the organization
- SWAG – Stuff We All Get

Compensation cost

Compensation must be reasonable for work performed based on comparisons to:

- Firms of the same size
- Firms in the same industry
- Firms in the same geographic area
- Firms engaged in non-government work

Establish a compensation plan

Current published compensation cap (12/31/21): \$568,000

Calculated compensation cap (12/31/22): \$589,000

https://www.whitehouse.gov/wp-content/uploads/2021/05/ContractorCompensationCapContractsAwardedafterJune24_2021.pdf

Economic Planning

Allowable

- Economic planning costs are the costs of general long-range management planning that is concerned with the future overall development of the contractor's business
- May take into account the eventual possibility of economic dislocations or fundamental alterations in those markets in which the contractor currently does business.

Unallowable

- Organization costs covered in FAR 31.205-27
- Economic planning connected to a specific merger, acquisition or divestiture

Employee Morale

Allowable

- Aggregate costs incurred on activities designed to improve working conditions, employer- employee relations, employee morale, and employee performance (less income generated by these activities) are allowable, subject to the limitations contained in this subsection. Some examples of allowable activities are –
 - House publications
 - Health clinics;
 - Wellness/fitness centers;
 - Employee counseling services; and
 - Food and dormitory services for the contractor’s employees at or near the contractor’s facilities.
- Costs of employees’ participation in company sponsored sports teams or employee organizations designed to improve company loyalty, teamwork, or physical fitness.

Unallowable

- Costs of gifts are unallowable. (Gifts do not include awards for performance made pursuant to 31.205-6(f) or awards made in recognition of employee achievements pursuant to an established contractor plan or policy.)
- Costs of recreation are unallowable
- Losses on operation of cafeterias & dormitories EXCEPT in specific circumstances

Idle Facilities

Allowable

- Necessary to manage workplace fluctuations
- Were necessary when acquired and are now idle because of changes in requirements, production economies, reorganization, termination, or other causes which could not have been reasonably foreseen.
- Costs of idle facilities are allowable for a reasonable period, ordinarily not to exceed 1 year

Unallowable

- Idle facilities in excess of one year
- Idle facilities where no effort has been made to sublet, rent or sale

IR&D/B&P

Allowable

- IR&D and B&P are allowable as indirect expenses on contracts to the extent that those costs are allocable and reasonable.
- Deferred IR&D where the total amount can be identified, the proration is supported and the contractor either had not government contracts or did not allocate IR&D to the government
- IR&D costs incurred by a contractor cooperative arrangements should be considered as allowable IR&D costs if the work performed would have been allowed as contractor IR&D had there been no cooperative arrangement

Unallowable

- IR&D costs that were incurred in previous accounting periods are unallowable

Precontract costs

Allowable

- Costs incurred before the effective date of the contract directly pursuant to the negotiation and in anticipation of the contract award when such incurrence is necessary to comply with the proposed contract delivery schedule
- Allowable to the extent that they would have been allowable if incurred after the date of the contract

Legal Costs

Allowable

- General legal costs related to operation of the business
- Support PRIOR to contracting officer's final decision
- General patent guidance

Unallowable if incurred in connection with:

- Defense against Federal Government claims or appeals or the prosecution of claims or appeals against the Federal Government
- Organization, reorganization, (including mergers and acquisitions) or resisting mergers and acquisitions
- Defense of antitrust suits
- Defense of suits brought by employees or ex-employees of the contractor under section 2 of the Major Fraud Act of 1988 where the contractor was found liable or settled
- Costs of legal, accounting, and consultant services and directly associated costs incurred in connection with the defense or prosecution of lawsuits or appeals between contractors arising from teaming agreements
- Patent infringement litigation, unless otherwise provided for in the contract
- Protests of Federal Government solicitations or contract awards, or the defense against protests of such solicitations or contract awards, unless the costs of defending against a protest are incurred pursuant to a written request from the cognizant contracting officer

Travel

Allowable

- Costs for transportation, lodging, meals, and incidental expenses
- Costs for transportation may be based on mileage rates, actual costs incurred, or on a combination thereof, provided the method used results in a reasonable charge

Unallowable

- Costs in excess of federal per diem rates
- First class airfare
- Airfare costs in excess of the lowest priced airfare available to the contractor during normal business hours
- Unsupported expenses

Unallowable vs. unbillable

- Not allowed per the terms of the contract
- Incurred outside the period of performance
- Costs in excess of funding
- Voluntary reductions in cost



TrUE/FALSE

Your company Christmas party is an allowable expense

- a) True
- b) False



COMMON COST HAZARDS



Common Cost Hazards

General

- Lack of supporting documentation, i.e., receipts, purchase orders, contracts
- Failure to document why a cost is reasonable in real time
- Failure to exclude unallowable costs from proposals
- Failure to treat costs found to be unallowable in a Contracting Officer's Final Decision (COFD) as *expressly* unallowable
- Failure to identify unallowable costs within the accounting system
- Failure to identify directly associated costs

Common Cost Hazards

Compensation

- Failure to include all components of compensation when comparing total compensation to regulatory compensation caps (Bonus, long term incentive comp, etc.)

IR&D/B&P

- Failure to capture in projects as a final cost objective and burden appropriately

Advertising/Recruiting

- Advertising must describe the specific position

Accrued Bonuses

- Failure to true-up to actual bonuses paid

Idle facilities

- Failure to document attempts to sublease or dispose of space

Common Cost Hazards

Consultant Costs

- Failure to document purpose of consultant and detail specific services provided

Depreciation

- Failure to use salvage value or document reason for estimating salvage value at \$0

Insurance

- Self-Insured plans should be approved by the government; must show that costs are reasonable

Relocation Costs

- Must be refunded to the government if the employee resigns within 12 months

Bonuses

- Lack of a documented bonus plan with metrics



BEST PRACTICES

Best practices

Properly segregate direct, indirect costs and unallowable costs. A typical account structure looks like this:

- 1XX Series – Assets
- 2XX Series – Liabilities
- 3XX Series – Equity
- 4XX Series – Revenue
- 5XX Series – Direct Costs (Direct Labor, Direct Materials)
- 6XX Series – Intermediate Cost Pools (Fringe, Occupancy, etc.)
- 7XX Series – Overhead Cost Pools (Engineering, Manufacturing)
- 8XX Series – G&A Cost Pools (Administrative, Marketing, IR&D, B&P)
- 9XX Series – Unallowable Expenses

Best Practices



Comply with GAAP



Train your people annually



Have clear policies



Identify unallowable costs on the front end



Identify costs as unallowable on expense reports, purchase orders, etc.



Track directly associated costs



SPECIAL TERMS & CONDITIONS



Contracts with Special Terms

Individual contracts may dictate the treatment of certain costs. Your contract may:

Clearly enumerate specifically unallowable costs. Note these are expressly unallowable and subject to penalty

Simply may not include costs (unallowable by omission) such as travel. These often result in unbillable direct costs

Call for a cost to be treated as direct that is normally treated as indirect by a contractor

Call for a cost to remain unburdened even if it is your normal cost accounting practice to do so

True/False

The allowability of costs is black & white

- a) True
- b) False

QUESTIONS?

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