

Cost Reimbursement Contracting:

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Agenda

- Why: History and Challenges
- How: Types, Source Selection, Competition and TINA
- Who: ACOs and Auditors
- What: Performance and Administration
- Where: Getting Paid, Cost Accounting Requirements
- When: Incurred Cost Submissions, Rates and Close-Out

Polling Question

Where are you working from today?

- a) Corporate Office
- b) Home
- c) Travel/Vacation Location
- d) Coffee Shop
- e) Other




Why: History and Challenges

- What is a Contract?
- The Pendulum Swing




What is a Contract?

✦ AI Overview

Learn more 

A contract is a legally binding agreement between two or more parties that creates enforceable obligations. The six essential elements of a contract are:

- Offer: The offeror communicates their terms to the offeree
- Acceptance: The offeree accepts the offeror's terms and conditions
- Awareness: Both parties are aware that they are entering into an agreement
- Consideration: Each party promises to do something to execute the contract
- Capacity: All signatories must understand the contract's obligations, terms, and consequences
- Legality: Other factors may affect the legality of a contract, such as mental capacity, minors, and contracts that must be in writing 

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The Pendulum Swing

- WWI – Use of Cost Plus a % of Cost Contracting to obtain urgently needed supplies and equipment
 - Congressional investigations concluded motivation to increase cost and banned the contract type
- WWII – CPFF most popular
- 1960's – DoD review identified excessive use of CR contracts as “weakness” and moved to more fixed-price effort
- 1970's – Policy guidance allowed CR contracts
- 1980's – DoD concluded CR contracts too widely used – issued major development contracts as fixed-price
- 1990's – Agencies returned to a balanced approach between CR and FP effort
- Mid-2000's – Another wave of criticism of CR contracts
- Today – Reinvigorated emphasis on preference for fixed-price contracts

How: Types, Source Selection, Competition and TINA

- Types of Contracts
- Type of Cost Type Contracts
- Proposal Evaluation



Purpose of Cost Reimbursement Contracts

- Permits the parties to undertake projects that involve substantial uncertainties
- Provides greater flexibility during performance than under fixed price contracts
- Allocation of risk:
 - The contractor assumes virtually no cost risk
 - If the work cannot be completed at the original cost estimate – the government must provide additional funding or accept partial performance
 - The contractor's primary risk is that additional funding is generally provided with no increase in fee or a reduction in fee
- If the contractor is generally paid for the cost of correcting deficiencies
- If the contractor is found in default, they are still compensated for cost incurred

Factors in Selecting A Contract Type

- Attainment of effective price competition
- Performance of a realistic price analysis
- Identification of performance uncertainty and their possible impact on price
- Type and complexity of the requirement
- Urgency of the requirement
- Period of performance or length of production run
- Contractor's technical capability and financial responsibility
- Adequacy of the contractor's accounting system
- Acquisition history

Polling Question

What is the majority of your contract mix?

- a) Firm Fixed Price - Government
- b) Time & Materials - Government
- c) Cost Reimbursable - Government
- d) Commercial
- e) Not applicable

Negotiating Contract Type – FAR 16.103

- Selecting the contract type is generally a matter for negotiation and requires the exercise of **sound judgment**
- Negotiating the **contract type** and **negotiating prices** are closely related and should be considered together
- Objective is to negotiate a contract type and price (or estimated cost and fee) that will result in **reasonable contractor risk** and provide the **greatest incentive for efficient and economical performance**
- **A firm-fixed-price contract**, which best utilizes the basic profit motive of business enterprise “**shall** be used when the **risk involved is minimal** or can be predicted with an acceptable degree of certainty”

Two Families of Contracts

- Fixed Price
- Cost Reimbursement

Fixed-Price Contracts - FAR 16.2

- Contractor must complete project at Fixed Price, regardless of cost growth.
- Contract price does not depend on cost; if the work doesn't change, the price doesn't change.
- Risks and rewards are with the contractor – every dollar saved goes to profit.
- Easy to administer for government, but not necessarily for contractor.
- Best Practice: Draft and administer contract to avoid “changes” claims (i.e., scope creep).

Fixed-Price Contracts

- Suitable for acquiring supplies or services based on reasonably defined specifications and known cost history.
- The CO must establish fair and reasonable prices at award:
 - Adequate price competition;
 - Price comparisons with prior purchases; or
 - Cost or pricing information that permits realistic cost estimates
- Appropriate when the performance risk is low (e.g., mature technology, proven processes).
- Government generally must use FFP (or FP-EPA) contracts for Part 12 acquisition of commercial items.
- Generally not appropriate for R&D contracts.

Cost Contracts - FAR 16.3

- Common Characteristics
 - Contractor Only Required to Use Best Efforts
 - Contractor Only Paid Reasonable, Allocable and Allowable Costs (not all costs)
- Limitations on Use
 - Adequate Accounting System
 - Ability to Administer
 - Limitation of Costs/Funds Clauses
- Fee Limitations
 - CPFF R&D = 15%, Other = 10%
- Payments during contract

Cost-Reimbursement Type Contracts

- Appropriate when there is a high degree of uncertainty:
 - Cutting edge technology
 - Unproven processes
 - Labor hours and labor mixes
 - Material costs
 - Learning curve
 - Unpredictable expenses
- Government assumes maximum performance/cost risk, but receives benefits of cost savings.
- Contractor realizes higher margin by reducing costs or exceeding objective performance criteria.

Cost-Reimbursement Type Contracts

- Must contain specific payment and funding terms.
- Contractor must have an accounting system that is capable of segregating cost elements.
 - Government will review and approve billed costs.
 - Government may disallow unapproved costs.
- Government pays monthly on a provisional basis (“forward pricing rates”) until books are closed at end of the contract.
 - The Government may retroactively disallow costs.
 - This often results in protracted contract closeouts.
 - Best Practice: How to avoid delayed closeout?
 - Start preparing at award!
 - Consider Quick Closeout procedures. (FAR 42.708)

Limitation Clauses

- Limitation of Cost Clause (fully funded) = FAR 52.232-20
- Limitation of Funds Clause (incrementally funded) = FAR 52.232-22
 - Contractor must give advance notice when approaching funding limit (e.g., 60 days before KR reaches 80% of funding, based on current EAC).
 - Contracting Officer must tell contractor whether additional funding is available.
 - Contractor is not required to spend above ceiling, and may not recover excess costs.
- Contractors often perform “at risk” – why?
- What if provisional indirect rates are later revised upward?
- Risk Factors:
 - Failure to provide written notice to CO
 - Failure to track costs
 - Performing at risk because funding is promised

Incentive Contracts

- Contractor and government share risk
 - Contractors can get greater fee by performing efficiently
 - Government incentivizes lower costs, faster performance
- Objective – “Incentive Fee” contracts:
 - Profit determined by formula, based on actual results – generally uses cost criteria, which can be “easily” measured. Can use Cost Plus Incentive Fee (“CPIF”) or Fixed Price Incentive Contract (“FPI”).
- Subjective – “Award Fee” contracts:
 - Profit determined by Government’s appraisal of contractor’s performance, using cost and other performance criteria. Can use Cost Plus Award Fee Contract (“CPAF”) or Fixed Price Award Fee Contracts (“FPAF”).

Letter Contracts - FAR 16.603

- Used to start performance while negotiating a definitized contract.
 - Immediate performance is needed
 - Not enough time to negotiate definitive contract
 - Must be definitized within 180 days or before 40% completion
- Can be Fixed Price or Cost Reimbursement
- Limitations:
 - Amount committed cannot exceed funds available at time letter contract is executed.
 - Letter contracts cannot be used to circumvent competition requirements in FAR Part 6.
 - Requires approval of Head of Contracting Authority.
- Question: How does use of letter contract affect Government's and Contractor's negotiation leverage?

Choice of Contract Type

- Government preference is Firm-Fixed-Price contract:
 - FAR 16.103(b) – best utilizes basic profit motive of business enterprise.
 - FAR 16.104(a) – fixed-price contract ordinarily in Government’s interest.
- Preference for acquisition of commercial items when available to meet needs of agency (and for prime contractors to acquire commercial items “to the maximum extent practicable”). FAR 12.101
- If no reasonable basis exists for firm pricing, other contract types should be considered:
 - Should tie profit to Contractor performance. FAR 16.103(b).
 - Contract type and price should be evaluated together. FAR 16.103(a).
 - Should be tailored to the statement of work (SOW), specifications and/or deliverables.

Polling Question

What contract type imposes the greatest compliance burden onto contractors?

- a) Firm Fixed Price
- b) Time & Materials
- c) Cost Reimbursable
- d) Other

Statutory/Regulatory Limitations

- Sealed Bidding – FAR Part 14
 - No Cost-Reimbursement Contracts
- Competitive Negotiations – FAR Part 15
 - May use any type of contract or a combination of types
- Commercial Item Acquisitions – FAR Part 12
 - No Cost-Reimbursement Contracts
- DOD Research & Development contracts (R&D) – DFARS 235.006
 - Limits on use of Fixed Price contracts for R&D
- Cost-Plus-a-Percentage-of-Cost Contracts
 - Simply prohibited

Rationale for Use of Cost Reimbursement Contracts

- FAR 16.301-1 Description.
- Cost-reimbursement types of contracts:
 - provide for payment of allowable incurred costs, to the extent prescribed in the contract
 - establish an estimate of total cost for the purpose of obligating funds and establishing a ceiling that the contractor may not exceed (except at its own risk) without the approval of the contracting officer

Key Obligations of the Contractor

- Make best effort to meet contract objectives
- Report status toward meeting objectives
- Report Cost Overruns/Underruns
- Two Forms
 - Completion form - states a definite goal or target and specifies an end product.
 - Term form- scope of work is general and obligates the contractor to devote a specified level of effort for a stated time period.

Cost Reimbursement Contract Limitations

- A cost-reimbursement contract may be used only when--
 - The contractor's accounting system is adequate for determining costs applicable to the contract; and
 - Appropriate Government surveillance during performance will provide reasonable assurance that efficient methods and effective cost controls are used.
- The use of cost-reimbursement contracts is prohibited for the acquisition of commercial items.
- Statutory fee limitations
- Determination and Findings Requirements

Basic Types of Cost Reimbursement Contracts

- Cost sharing
- Cost reimbursement
- Cost plus fixed fee
- Cost plus award fee
- Cost plus incentive fee

Cost Sharing

Contract type requires the contractor to share in the cost of the contract

Used primarily for research and development effort where both will benefit

Used extensively in the university environment

Not overly attractive to contractors since it requires an investment

Cost Reimbursement

Reimburses the contractor for the costs incurred to perform the contract
– no fee

Normally used to continue research beneficial to both parties

No investment required

Lack of fee may be a significant disadvantage

Cost Plus Fixed Fee

Perennial favorite

Contractor is reimbursed for costs incurred plus a fixed fee

Cost plus fixed fee contract allocates more risk to the Government

Two types: Completion and Term

Cost-Plus-Fixed-Fee Contracts

- CPFF Contracts impose the most cost and performance risk to the Government and the least to the Contractor.
 - Contractor has minimal responsibility for performance costs and minimal incentive to control costs.
 - Requires greatest Government audit and oversight.
 - Used when efforts might otherwise present too great a risk to the Contractor.
- Negotiated fee (profit) is fixed at contract inception.
 - Fee does not vary with actual costs.
 - Fee includes profit plus allowance for unallowable costs.
 - Fee may be adjusted if the contract scope changes.

CPFF Example

• Cost Estimate (negotiated)	=	\$800,000
• Fee (negotiated)	=	<u>\$64,000</u>
• TOTAL CPFF Award Amount	=	\$864,000

- What if actual cost incurred = \$700,000?
- What if actual cost incurred = \$900,000?
- What will contractor be paid?
- What is contractor's incentive to be efficient?

Cost Plus Award Fee

Made up of estimated cost, base fee and award fee

Government defines what makes up the award criteria

Contractor can not appeal the amount of the award

Facilitates discussion

Motivates contractor to do that which will be rewarded

Award periods and criteria must be clearly stated

Base fee – In essence a fixed fee element - capped at 3% at DoD

CPAF Example

• Cost Estimate (negotiated)	=	\$800,000
• Award Fee Pool (negotiated)	=	<u>\$80,000</u>
• TOTAL CPAF Award Amount	=	\$8??,???

- What if Award Fee Board scores a 90?
- What if actual cost incurred = \$900,000?
- What will contractor be paid?
- What is contractor's incentive to be efficient?

Cost Plus Incentive Fee

Components of cost plus incentive fee include: Target cost, Target fee, Maximum fee, Minimum fee and Sharing arrangement

Focuses contractor effort on what the Government thinks is important

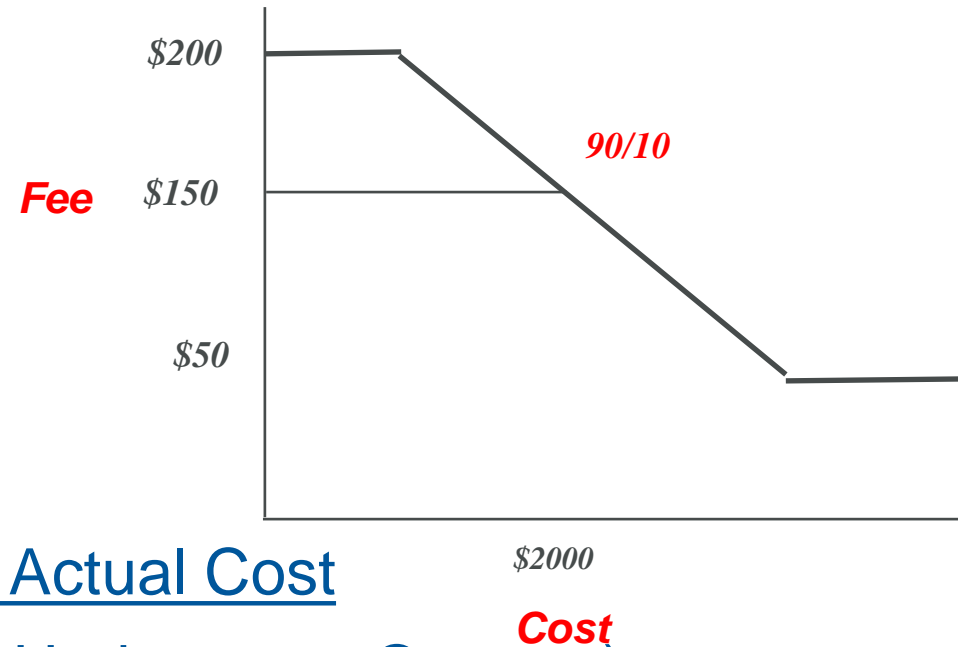
Incentives often are “build cheap”

Cost-Plus-Incentive-Fee Contracts

- Key elements:
 - Initially negotiated target cost
 - Initially negotiated target fee
 - Government/Contractor sharing arrangement
 - Maximum fee recoverable by the Contractor
 - Minimum fee recoverable by the Contractor
 - Fee adjustment formula
- Fee is adjusted upward or downward by the sharing formula, based on the relationship of “total allowable costs” to “total target costs.”
- Fee is paid to Contractor after contract performance, once total allowable costs are determined.

Incentive Fee Example

- Target Cost: \$2000
- Target Fee: \$150
- Maximum Fee: \$200
- Minimum Fee: \$50
- Sharing Arrangement: 90/10
- 1. Underrun or Overrun = Target Cost – Actual Cost
- 2. Adjusted Fee = Target Fee + (10% of Underrun or Overrun)
- 3. Final Price = Actual Cost + Adjusted Fee
 - What if actual cost incurred = \$2,200?
 - What if actual cost incurred = \$1,900?



Cost Plus Percentage of Cost

Statutorily Prohibited Arrangement

Payment Specified as Rate

Rate Applied to Actual Costs

Entitlement Unknown at award

Entitlement increases with Cost

Common Misconceptions

- Contractor has no cost risk
- Government does not receive a deliverable
- What ever the contractor spends, the contractor receives

Evaluating Proposals

- Price Analysis
- Cost Analysis
 - Certified Cost or Pricing Data implications
 - Cost Accounting Standards implications
- Cost Realism

Polling Question

Cost Realism is performed for:

- a) Fixed Price Contracts
- b) Cost Reimbursement Contracts
- c) Both



Approaches to Contract Pricing

- Price analysis considerations
- Cost analysis considerations
- Cost realism analysis considerations

Price Analysis Considerations

- Definition of Price Analysis. Price analysis is the process of examining and evaluating a proposed price to determine if it is fair and reasonable, without evaluating its separate cost elements and proposed profit. Price analysis may be, when necessary, supplemented by evaluation of cost elements.
- Price analysis must be performed for ALL procurement to ensure that the overall price is fair and reasonable.

Basis for Price Analysis

- Price analysis always involves some form of comparison with other prices such as:
 - Proposed prices received in response to the solicitation;
 - Commercial prices including competitive published price lists, published commodity market prices, similar indexes, and discount or rebate arrangements;
 - Previously-proposed prices and contract prices for the same or similar end items, if you can establish both the validity of the comparison and the reasonableness of the proposed price;
 - Parametric estimates or estimates developed using rough yardsticks;
 - Independent Government Estimates; or
 - Prices obtained through market research for the same or similar items

Cost Analysis Considerations

- Definition of Cost Analysis. Cost analysis is the review and evaluation of the separate cost elements and proposed profit/fee of:
 - An offeror's or contractor's cost or pricing data or information other than cost or pricing data and
 - The judgmental factors applied in projecting from the data to the estimated costs.
- The purpose of the evaluation is to form an opinion on the degree to which the proposed costs represent what the cost of the contract should be, assuming reasonable economy and efficiency.

When to Perform Cost Analysis

- Perform cost analysis in either of the following situations:
 - When the Truth in Negotiations Act (TINA) applies and the offeror is required to submit cost or pricing data. In this situation, the offeror must provide complete, accurate, and current data to support all proposed costs and profit/fee.
 - When you require an offeror to submit cost information other than cost or pricing data to support your decision on price reasonableness or cost realism.
- Require only the information necessary to determine price reasonableness or cost realism!

Cost Realism Analysis Considerations

- Definition of Cost Realism Analysis. Cost realism analysis is the process of independently reviewing and evaluating specific elements of each offeror's proposed cost estimate to determine whether the estimated proposed cost elements:
 - Are realistic for the work to be performed;
 - Reflect a clear understanding of the requirements; and
 - Are consistent with the unique methods of performance and materials described in the offeror's technical proposal.
- When to Use Cost Realism Analysis
 - All cost-reimbursement contract offers to determine the probable cost of contract performance
 - may be used in evaluating competitive offers for fixed-price incentive contracts or, in exceptional cases, on other fixed-price contracts.

Negotiation of Cost and Fee

- Cost Estimate
 - Certified Cost or Pricing Data
 - Data Other Than Certified Cost or Pricing Data
 - Subcontractors
 - Cost Allowability
- Profit
 - FAR guidelines
 - Weighted Guidelines – Cost Risk near zero

Who: ACO's and Auditors



FAR Part 42

- Cognizant Auditors – FAR 42.1
 - DoD uses DCAA
 - Civilian Agencies can use DCAA, may use internal or external auditors
- Administrative Contracting Officers
 - Administration – FAR Part 42.2 – 71 Separate Administrative Functions
 - DoD uses DCMA
- Indirect Cost Rates – FAR 42.7
- Forward Pricing Rate Agreements – FAR 42.17

What: Performance and Administration

- Accounting System
- Changes and Modifications
- Inspection and Defects
- Terminations
- Property



Contractor Accounting System

- Accounting System Definition
 - System or systems for accounting methods, procedures, and controls
 - established to gather, record, classify, analyze, summarize, interpret, and present accurate and timely financial data
 - for reporting in compliance with applicable laws, regulations, and management decisions
 - May include subsystems for specific areas such as indirect and other direct costs, compensation, billing, labor, and general information technology.

Contractor Accounting System

- SF 1408, Preaward Survey of Contractor Accounting System
- DFARS 252.242-7006, Accounting System Administration Requirements
 - The Contractor shall establish and maintain an acceptable accounting system
 - Clause included in:
 - Cost-reimbursement, incentive type, T&M, or labor-hour contracts
 - Fixed-price contracts with progress payments made on the basis of costs or on a percentage or stage of completion
- Adequate accounting system
 - Complies with the system criteria
 - Provide for compliance with applicable laws and regulations
 - Accounting system and cost data are reliable
 - Risks of misallocations and mischarges are minimized, and
 - Contract allocations and charges are consistent with billing procedures

Contractor Accounting System

- Significant deficiency
 - Shortcoming that materially affects DoD ability to rely upon information needed for management purposes
 - Will result in withholding of payments if the contract includes DFARS 252.242-7005, Contractor Business Systems
- May also result in disapproval of the system

Polling Question

An accounting system must be approved by the ACO or the cognizant auditor for a company to be awarded a cost reimbursement contract:

- a) True
- b) False

Criteria - DFARS 252.242-7006

1. A sound internal control environment and accounting framework and organizational structure
2. Proper segregation of direct costs from indirect costs
3. Identification and accumulation of direct costs by contract
4. A logical and consistent method for the accumulation and allocation of indirect costs to intermediate and final cost objectives
5. Accumulation of costs under general ledger control
6. Reconciliation of subsidiary cost ledgers and cost objectives to general ledger
7. Approval and documentation of adjusting entries
8. Periodic monitoring of the system
9. A timekeeping system that identifies employees' labor by intermediate or final cost objectives
10. A labor distribution system that charges direct and indirect labor to the appropriate cost objectives

Criteria - DFARS 252.242-7006

11. Interim (at least monthly) determination of costs charged to a contract through routine posting of books of account
12. Exclusion from costs charged to Government contracts of amounts which are not allowable in terms of FAR Part 31, Contract Cost Principles and Procedures, and other contract provisions
13. Identification of costs by contract line item and by units (as if each unit or line item were a separate contract), if required by the contract
14. Segregation of preproduction costs from production costs, as applicable
15. Cost accounting information, as required
 - (i) By contract clauses concerning limitation of cost (FAR 52.232–20), limitation on payments (FAR 52.216–16), or allowable cost and payment (FAR 52.216–7); and
 - (ii) To readily calculate indirect cost rates from the books of accounts;
16. Billings that can be reconciled to the cost accounts for both current and cumulative amounts claimed and comply with contract terms
17. Adequate, reliable data for use in pricing follow-on acquisitions
18. Accounting practices in accordance with CAS, if applicable, otherwise, GAAP

Contractor Accounting System

- Expectations/Focus
 - General Ledger ties to Subsidiary Ledgers
 - Adequate Job Cost or Process Cost System
 - Adequate Timekeeping Procedures and Labor Distribution
 - Adequate and Compliant Policies Defining:
 - Direct vs. Indirect Costs
 - Indirect Cost Pools and Allocation Bases
 - Screening for Unallowable Costs

Contractor Accounting System

- Common Deficiencies
 - Failure to make interim (monthly) determination of costs charged to contracts through routine posting to accounts
 - Failure to segregate direct and indirect costs
 - Improper timekeeping
 - Failure to segregate and exclude unallowable costs
 - Failure to include unallowable costs in base

Polling Question

Only DCAA can approve an accounting system:

- a) True
- b) False

Contract Modifications – Change Orders

- Changes clause authorizes unilateral changes
 - Equitable adjustment of—
 - Estimated cost
 - Schedule
 - Fixed fee
 - Other affected terms

Contract Modification – Funding

- Funds must be available
- Modification does not automatically increase—
 - Estimated cost
 - Funds allotted
- Modification does not need to be funded immediately (but contractors must take caution!)

Funding

- Minimal FAR coverage (FAR 32.7)
 - Adding money (obligations)
- Contractor agreement not required
- Covered in Limitation of Cost/Funds (LOC/LOF) clauses

Contract Management – Funding Changes

- Deleting money
- May require contractor agreement
- May be —
 - Constructive change
 - Constructive suspension
 - Constructive termination

Constructive Changes

- Informal changes
- Made by authorized or unauthorized person
- May be intentional or unintentional
- May cause cost growth
- May entitle contractor to fee
- Must be recorded/reported

Quality Assurance

- Inspection and acceptance
- Contractor must —
 - Provide, maintain, and inspect system
 - Inspect supplies and services
 - Make records available to government
 - Correct defects
- Government has right, not duty, to inspect

Correction of Defects

- Supply and R&D contracts
 - Obligation continues 6 months after acceptance
 - Costs of correction reimbursable, unless caused by managerial fraud, misconduct, or careless, unqualified employee - but no additional fee is provided
- If services are correctable
 - Contractor must correct
 - Costs of correction are reimbursable but no additional fee
- If services are not correctable the Government may reduce the contract fee

Termination of Contracts

- Government may terminate for
 - Convenience
 - Default
- Termination is
 - In whole or in part
 - At once or from time-to-time

Convenience Termination

- 52.249-9 Termination (Cost-Reimbursement)
 - All allowable costs within funding
 - Subcontractor settlement costs
 - Settlement proposal costs
 - Storage, transportation, costs, and so on
 - Fee equal to percentage completion

Default Termination

- 52.249-9 Termination (Cost-Reimbursement)
 - All allowable costs within funding
 - Subcontractor settlement costs
 - Storage, transportation costs, and so on
 - Fee for accepted work
- Unlike fixed price contracts, the Government cannot recover procurement costs on cost reimbursement contracts

Contractor's Government Property Responsibilities

- Upon delivery of property, contractor:
 - Files a statement of any overages, shortages, or damages
 - Identifies, marks, and records property actually received
 - Furnishes a receipt, if necessary

Contractor's Government Property Responsibilities

- When property is no longer needed, contractor:
 - Prepares inventory schedules
 - Corrects inaccurate or incomplete inventory schedules
 - Executes the inventory schedule certificate

Contractor's Government Property Responsibilities

- During contract period, contractor:
 - Maintains the property control system
 - Obtains all required approvals for property use
 - Uses the property for authorized purposes
 - Segregates government property from contractor property
 - Maintains, repairs, protects, and preserves the property
 - Periodically inventories the property
 - Keeps required property records
 - Files all required reports

Polling Question

As long as you have an approved software (i.e. Deltek, Unanet, Jamis, etc.), you are guaranteed to have an approved accounting system:

- a) True
- b) False

Where: Getting Paid, Cost Accounting Requirements

- Allowable Cost and Payment
- Invoicing
- Cost and Accounting Rules



Allowable Cost and Payment – FAR 52.216-7

- Invoicing
- Reimbursing Costs
- Small Business Concerns
- Final Indirect Cost Rates
- Billing Rates
- Quick-Closeout Procedures
- Audit
- Final Payment

Provisional Payment

- Payment request submitted on Public Vouchers SF1034 and 1035
- Continuation sheets reflecting attendance often required by the contracting officer
- Subject to audit

Payment of Fee

- Contractor is paid up to 85 percent of fixed fee
- Contractor can be paid all of the fixed fee if the Government's interest is protected (FAR 52.216-8)

Cost and Accounting Rules

- Cost Principles – FAR Part 31
 - Determination of total cost
 - Allocation of costs as direct or indirect
 - Determination of cost allowability
- Cost Accounting Standards - 48 CFR Part 99
 - Small businesses are exempt
 - Consistency requirement for cost accounting practices used for estimating, accumulating and reporting costs
 - Guidance on cost allocation, measurement and assignment
 - May require Disclosure Statements

Composition of Total Cost – FAR 31.201-1

- Direct cost - FAR 31.202
- Indirect cost - FAR 31.203
- Cost of Money – FAR 31.205-10

Direct Cost – FAR 31.202

- A direct cost can be specifically identified with a particular final cost objective.
- Rule of 5. To be a direct cost, it must be:
 - able to be measured
 - capable of being accumulated
 - worth tracking
 - able to be estimated
 - able to be sold to the customer
- Similar costs incurred for the same purpose must also be a direct cost.
- Insignificant direct costs can be treated as indirect costs

Indirect Cost — FAR 31.203

- A cost not directly identified with a single final cost objective. Left over after all direct costs are assigned.
- Includes overhead and G&A
- Rule of 4. For indirect costs, you must be able to:
 - track pool and base
 - generate timely reports
 - project the rates with some certainty
 - sell the rates to a customer
- Similar costs incurred in similar circumstances must also be indirect.
- Must select an allocation base with a causal or beneficial relationship to the pooled costs.

Indirect Cost Structures

- Established by contractor
- Dependent upon nature of business environment
 - Functional considerations
 - Off-site versus on-site considerations
 - Management informational needs
- Often more than one method is acceptable
- Should result in equitable distribution of indirect costs to final cost objectives

More on indirect costs

- No fragmenting the base by removing individual elements
- All items properly includable in base to bear a pro rata share regardless of acceptance as Government contract costs
- Method may require revision for significant change in the nature of the business
- Offsite rates may be necessary for equitable distribution
- Fiscal year used for accumulation and distribution of indirect costs
- Exception for fiscal year changes due to business combinations

Allocating Indirect Costs

- Pool – logical grouping of indirect costs with similar relationship to the cost objective(s)
- Base –direct activity that will be used to allocate pool costs (causal beneficial relationship)
- Allocation (Indirect) Rate – Pool divided by Base
- Same cost can not be in both pool and base

Service Centers

- Service Center = Cost Pool
- Costs are allocated on some measureable element other than cost based on the use of the service
- Provides information on the cost of providing the service
- Costs may be allocated to contracts, other indirect pools, or other service centers
- Examples:
 - Computer help desk
 - Copying and Printing
 - Technical support

Home Office Expenses

- Costs need to be allocated on a base that reflects a causal or beneficial relationship
- Three steps to the allocation process:
 - Specific identification
 - Homogeneous cost pools
 - Three factor formula

B&P and IR&D

- Bid and Proposal (B&P) and Independent Research and Development (IR&D) costs
 - B&P: Costs incurred to prepare, submit, and support contractor bids and proposals
 - IR&D: Costs for technical effort that is not sponsored by a contract, grant, or other arrangement and that falls in the area of basic and applied research and development
 - Costs consists of all direct labor, material, ODCs, and all applicable indirect and G&A costs
 - Most often allocated to contracts using the same base as used to allocate G&A

Polling Question

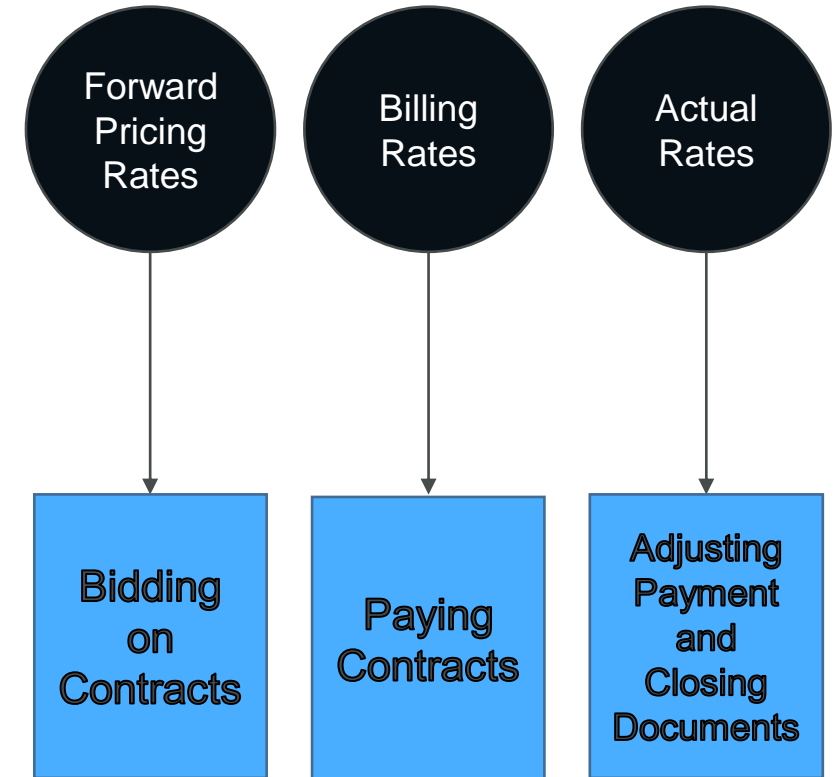
The government can dictate to a contractor what its indirect structure must be:

- a) True
- b) False

The Indirect Rate Life Cycle

- **Contractor Indirect Rate Cycle**

- Bid and bill with Provisional rates
- Monitor the Provisional rates versus Actual rates periodically.
- Compare the rates at the end of year, at Incurred Cost Proposal (ICP) submittal, and when the ICP is settled.
- Submit revised rates if there is a material difference throughout contract
- Submit final rates in ICP
- Settle final rates at contract closeout
- ICP rates are comprised of costs which are allocable, reasonable, and allowable on Government contracts.



Government Monitoring

- Government Team
 - Monitoring Techniques
 - Indirect Rate Life Cycle
 - Tracking Indirect Costs
 - Contractor Systems Reviews
 - Accounting (252.242-7006)
 - Estimating (252.215-7002)
 - Material Management & Accounting System (MMAS) (252-242-7004)
 - Earned Value Management (EVM) (252.234-7002)
 - Purchasing (252.244-7001)
 - Government Property (252.245-7003)

Contractor Management of Indirect Costs

- Planning
- Forecasting
- Budgeting
- Control
- Variance Analysis
- Ratio Analysis
- Trend Analysis
- Management Metrics
- Regression Analysis
- Industrial Engineering Analysis
- Contractor Actions to Reduce Overhead

Essentials for Understanding Indirects

- Allowable or Unallowable Costs
 - Reasonableness
 - Allocability
 - Allowability
 - CAS 405 or GAAP
 - Contract Terms or FAR 31.201
- Capitalized Versus Expensed
 - small general-purpose costs are:(1) typically classified as expenses and (2) placed into indirect-cost pools for subsequent allocation to many contracts.
 - larger amounts are classified as assets and are considered to be capitalized where only a portion of the costs is placed into indirect-cost pools in the form of a depreciation expense each year.
- Controllable or Non-controllable Costs
 - Responsibility Accounting / Manager Control

Cost Allowability – FAR 31.201-2

- Reasonableness
- Allocability
- Standards of the CASB or GAAP
- Terms of the Contract
- Cost Principle limitations

Reasonableness — FAR 31.201-3

- Definition
 - 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 a competitive business.
- Contractor has burden of proving reasonableness
- Normal concepts of reasonableness don't apply

Allocability – FAR 31.201-4

- Definition
 - Is incurred specifically for the contract
 - Benefits both the contract and other work and can be reasonably distributed
 - Is necessary for overall operation of the business
- Often draws improper disallowances
- Titles such as ‘Commercial Selling’ lead to misunderstandings

Allowability Requirements

- Contractor must maintain adequate accounting records – FAR 31.201(2)(c)
- Contractor must apply consistent practices – FAR 31.201(2)(b)
- Often subject to improper challenges due to poor chart of accounts or inadequate procedures.

Credits — FAR 31.201-5

- Income, rebate, allowance or other credit
- Cost reduction or cash refund
- Special rules on pension adjustments and asset reversions

Certificate of Indirect Costs

This is to certify that to the BEST OF MY KNOWLEDGE and belief:

- 1. I have reviewed the indirect cost proposal submitted herewith;
- 2. All costs included in this proposal [to establish billing or final indirect costs rates for . . .] are ALLOWABLE in accordance with the requirements of contracts to which they apply and with the cost principles of the Department of Defense applicable to those contracts;
- 3. This proposal DOES NOT INCLUDE ANY COSTS WHICH ARE UNALLOWABLE under applicable cost principles of the Department of Defense, such as (without limitation): advertising and public relations costs, contributions and donations, entertainment costs, fines and penalties, lobbying costs, defense of fraud proceedings, and goodwill; and
- 4. All costs included in this proposal are PROPERLY ALLOCABLE to defense contracts on the basis of a beneficial or causal relationship between expense incurred and the contracts to which they are allocated in accordance with applicable acquisition regulations.

I declare UNDER PENALTY OF PERJURY that the foregoing is true and correct.

Firm Title.....
Signature Date

Corporate Official



Penalties for Unallowable Cost

- If unallowable on clear and convincing evidence:
 - Disallowed cost plus interest on any paid portion
- If known to be unallowable before proposal submission:
 - Disallowed cost plus interest on any paid portion
 - Additional two times unallowable cost
 - Other civil and criminal penalties provided by law

Unallowable Cost Challenges

- Auditor expectation for supporting documentation
- DCAA audits in arrears and conflict with record retention requirements
- Auditor access to budgeted and incurred cost.

DCAA Guidance on Penalties

- Impacts all costs questioned by DCAA
- Three separate memos:
 - May 2019 – 19-PAC-002(R) – 35 pages
 - January 2015 – 14-PAC-022(R) – 10 pages
 - December 2014 – 14-PAC-021(R) – 34 pages
- Legal Interpretations
 - Raytheon Decisions
 - ASBCA Nos. 57576, et al (June 26, 2015)
 - ASBCA No. 57742, 2017 WL 1740026 (Apr. 17, 2017)
 - US Court of Appeals 2018-2371 (October 18, 2019)

Advanced agreements - FAR 31.109

- When should they be used
 - If you are willing not to do what you are proposing
 - Use charges on depreciated assets
- When should they be avoided
 - If you are going to do what you are proposing regardless of the advanced agreement

Polling Question

Whose responsibility is it to ensure unallowable costs are not included in claimed costs?

- a) DCAA
- b) Contracting Officer
- c) Contractor
- d) CPA audit firm

Specific Cost Principles

Personnel Cost Principles

- Compensation for Personal Services
- Employee Morale, Health, Welfare, Food Service, and Dormitory Costs and Credits
- Costs of Alcoholic Beverages
- Travel Costs
- Entertainment Costs
- Relocation Costs
- Trade, Business, Technical and Professional Activity Costs
- Training and Education Costs

Compensation for Personal Services — FAR 31.205-6

- Allowable subject to general criteria and additional requirements contained in this FAR cost principle
- General criteria includes:
 - Must be for work performed by the employee in the current year
 - Total compensation must be reasonable for the work performed
 - Must be based on the terms and conditions of contractor's established compensation plan or practice, consistently followed
 - Must not otherwise be made unallowable by FAR 31.2
 - Special considerations, including: owners of closely held corporations, members of limited liability companies, partners, sole proprietors, members of their immediate families

What is “Reasonable?”

- FAR 31.205-6(b)
- Factors CO may consider include:
 - Firms of the same size
 - Firms in the same industry
 - Firms in the same geographic area
 - Firms engaged in similar non-Government work in comparable circumstances
- Contractor bears responsibility to substantiate reasonableness
- Competition for labor and contract awards

Bonuses and Incentive Compensation

- FAR 31.205-6(f)
- Allowable if:
 - Based on agreement entered into in good faith between contractor & employees before services are rendered OR pursuant to established plan/policy; and
 - Basis for the award is supported

Limitation on Allowability of Compensation

- FAR 31.205-6(p)
- Executive compensation caps
- Compensation = sum of wages, salary, bonuses, deferred compensation and employer contributions to defined contribution pension plans for the fiscal year, whether paid, earned, or otherwise accruing, as recorded in the contractor's cost accounting records for the fiscal year
- Some compensation caps apply to “senior executives”
 - Prior to January 2, 1999: Chief Executive Officer (CEO) + Top 4
 - Top 5 at intermediate home offices or segments
 - Effective January 2, 1999: five most highly compensated employees in management positions at each home office and each segment

Keeping the Caps on Straight...

Table- Contractor Employee Compensation Cap Rules

Contract Award Date	Applicable Agencies	Covered Employees	Cap Rule	FAR 31.205-6
Before June 24, 2014	Executive Agencies other than DoD, NASA, and Coast Guard	Senior Executives	Statutory formula cap	(p)(2)
Before December 31, 2011	DoD, NASA, and Coast Guard	Senior Executives	Statutory formula cap	(p)(2)
On/after December 31, 2011, and before June 24, 2014	DoD, NASA, and Coast Guard	All Employees	Statutory formula cap	(p)(3)
On/after June 24, 2014	All Executive Agencies	All Employees	\$487,000 BBA cap	(p)(4)

Source: <https://obamawhitehouse.archives.gov/omb/procurement/ccp>

Compensation Caps

For Costs Incurred	Escalation	Cap Amount
1/1/2024 - 12/31/2024	4.4%	\$ 646,000.00
1/1/2023 - 12/31/2023	5.1%	\$ 619,000.00
1/1/2022 - 12/31/2022	3.7%	\$ 589,000.00
1/1/2021 - 12/31/2021	2.3%	\$ 568,000.00
1/1/2020 - 12/31/2020	2.8%	\$ 555,000.00
1/1/2019 - 12/31/2019	2.9%	\$ 540,000.00
1/1/2018 - 12/31/2018	2.5%	\$ 525,000.00
1/1/2017 - 12/31/2017	2.4%	\$ 512,000.00
1/1/2016 - 12/31/2016	2.7%	\$ 500,000.00
6/24/2015 - 12/31/2015		\$ 487,000.00

Source: <https://www.whitehouse.gov/wp-content/uploads/2023/11/ContractorCompensationCapContractsAwardedafterJune24-UPDATE-NOV-2023.pdf>

DCAA Approach to Reasonableness...

EXECUTIVE COMPENSATION REVIEW FOR CALENDAR YEARS 2010 THROUGH 2012

Sales	Executive	Claimed Cash Comp (1)	Survey Cash Compensation Results (2)				Survey Avg. + 10% ROR Cash Comp.	Total Unreasonable
			Towers Watson	ERI	HRA	Mercer		
	CY 2010							
\$16.0M	President	\$ 408,489	\$ 219,941	\$ 219,036	\$ 209,156	\$ 253,457	\$ 247,937	\$ 160,552
	CEO	468,140	288,378	319,724	259,374	341,566	332,487	135,653
	VP of A	325,387	ND	169,592	ND	196,272	201,225	124,162
	VP of B	325,234	ND	152,920	ND	162,728	173,606	151,628
	SR Analyst	232,316	ND	ND	ND	ND		
							Subtotal:	\$ 571,995
	CY 2011							
\$18.0M	President	\$ 457,863	\$ 227,963	\$ 219,844	\$ 214,708	\$ 263,056	\$ 254,532	\$ 203,331
	Director	529,097	300,519	315,966	266,259	355,554	340,532	188,565
	VP of A	342,544	ND	174,930	ND	218,277	216,264	126,280
	VP of B	348,306	ND	148,117	ND	159,299	169,079	179,227
	SR Analyst	231,260	ND	ND	ND	ND		
							Subtotal:	\$ 697,403
	CY 2012							
\$12.0M	President	\$ 429,698	\$ 218,036	\$ 201,387	\$ 220,720	ND	\$ 234,719	\$ 194,979
	Director	486,958	275,937	275,555	273,714	ND	302,576	184,382
	VP of A	316,340	ND	179,537	ND	ND	197,491	118,849
	VP of B	331,239	ND	149,948	ND	ND	164,943	166,296
	PM	173,428	ND	ND	156,423	ND	172,065	1,363
							Subtotal:	\$ 665,869
								\$ 1,935,267

DCAA Example

(2) SURVEYS USED TO DETERMINE THE REASONABLENESS OF EXECUTIVE COMPENSATION:

Before performing our review, we requested information from the contractor in order to understand and evaluate the basis of the claimed compensation costs and how the company establishes executive pay levels. XXXXXXXX, Inc. indicated its claimed compensation is based on management judgement. We were provided with very limited position descriptions for the executives in the request. Had the contractor provided more detailed position descriptions, some of our position matches might have been different from the survey matches used in our analysis. As a result, our conclusions could have been impacted had we been provided more detailed position descriptions. Also, we were unable to benchmark the Sr. BP Analyst in CY 2010 and CY 2011 without a more detail position description; therefore we could not determine the reasonableness of the claimed compensation. We were not provided with any other information to support the claimed compensation for the executives. We used the executive titles and the available position descriptions in the benchmarking of the executives, using the available surveys, below.

Towers Watson: 2010/2011 Top Management Comp Calculator by Towers Watson Data Services. We used regression analysis for median total cash compensation based on annual sales for the Chief Operating Officer and Chief Executive Office in the Engineering Services Industry.

ERI: Economic Research Institute Executive Compensation Assessor: July 1, 2010, July 1, 2011 and July 1, 2012 Databases. We used regression analysis for median total cash compensation based on annual sales for the Chief Operating Officer, Chief Executive Officer and Vice President using the North American Industry Classification System (NAICS) Code 541330, Engineering Services.

HRA: 2010 Compensation Survey Report, by Human Resource Association of The National Capital Area. We used the median total cash compensation based on companies with Gross Revenue Less Than \$25 Million for the Chief Operating Officer, Chief Executive Officer and Program/Project Senior Director.

Mercer: 2008 Mercer Benchmark Database Executive Survey Report by Mercer LLC. We used regression analysis for median total cash compensation based on annual sales for the Chief Operating Office, Chief Executive Officer and Top Division Executive from Professional Services.

SUMMARY: We have determined that a total of \$1,935,267 of the claimed cash compensation for the executives is unreasonable in accordance with FAR 31.205- 6(b)(2). The audit position is based on comparisons with the same or similar executive positions from organizations of similar size and industry as XXXXXXXX, Inc. All survey data was aged to the contractor's Calendar Year midpoints of June 30, 2010, June 30, 2011 and June 30, 2012 using Salary Budget Trend Data as published by WorldatWork. We were unable to benchmark the Sr. BP Analyst in CY 2010 and CY 2011 without a more detail position description; therefore we could not determine the reasonableness of the claimed compensation.

DCAA Updated Guidance

- Contract Audit Manual - 5-803.1
 - *“Often contractors will propose that their executives should be paid more than 110 percent of the reasonable compensation based on the average compensation paid by comparable firms for executives with similar duties. For an executive with responsibility for overall management of a segment or firm, such a proposal may be justified by clearly superior performance, as documented by financial performance that exceeds the particular industry's average.”*

Techplan Corp., ASBCA 41470

- Government's Position:
 - Challenged the allegedly above-average salary paid to Techplan's CEO and major shareholder
- Techplan's Position:
 - Techplan presented evidence showing its CEO's involvement in the company's high growth rate, sustained profitability, and reputation for quality
- ASBCA Decision:
 - Salaries were allowable in part because the FAR cost principles "allow the flexibility necessary to determine reasonableness based upon generally accepted practices in the compensation field."
Techplan "could reasonably elect to set the CEO's compensation at an above average level, i.e., at the 75th percentile"

J.F. Taylor, Inc., ASBCA 56105

- Facts:
 - Gov't disputed the reasonableness of compensation J.F. Taylor ("JFT") paid to four of its executives. Government relied on a discredited compensation expert and made no effort to rebut JFT's statistical arguments
 - JFT's statistical expert undermined DCAA's executive compensation review methodology stating "there is no substance behind the scientific veneer" of DCAA's mathematical model for determining unallowable executive compensation
 - DCAA's erroneously used an arbitrary 10% range of reasonableness that did not take into consider the actual dispersion among the survey data
- Decision:
 - "[M]ethodology used by DCAA was fatally flawed statistically and therefore unreasonable." DCAA's 10% range of reasonableness ignores actual amount of dispersion among survey data

Metron, Inc., ASBCA 56624

- Government's Position:
 - Issued a final decision denying and demanding repayment of Metron's executive compensation costs for two fiscal years based on a DCAA audit
 - In determining reasonableness, DCAA compared several compensation surveys and disagreed with Metron's classification of senior engineers as executives
- ASBCA Decision:
 - Metron met burden of proving questioned costs were reasonable and allowable
 - Found a single survey of high technology companies provided the best match when determining compensation amounts
 - 75th percentile was reasonable based on both financial and nonfinancial measures (e.g., PhDs and TS/SCI clearances)
 - DCAA's extrapolations & adjustments of survey data lacked any factual basis:
 - Additional survey data relied upon by DCAA "were not sufficiently comprehensive, reliable, relevant to Metron's industry, and/or the job matches were not sufficiently similar and representative to warrant material reduction of the results obtained from use of the Radford Survey data alone for the disputed positions"
 - Rejects DCAA's use of "division" revenues and concludes total revenue is appropriate benchmark

After J.F. Taylor and Metron

- DCAA continues to use similar methodologies:
 - Example: Defense Contract Audit Manual (“DCAM”) § 6-414.3, *Risks Considerations for Unreasonable Compensation*
 - “The auditor should ascertain that the contractor’s market pricing is compliant with FAR 31.205-6 and the process cited in the Techplan Corporation ASBCA Decision.” DCAM “process” includes factors such as:
 - + “Identify survey(s) of compensation for the position to be evaluated that match the company in terms of revenues, industry, geographic location and/or other relevant factors”
 - + “Update the surveys to a common data point for each year through the use of escalation factors”
 - + “Apply a range of reasonableness, such as 10 percent, to the number or numbers selected. It is DCAA policy to use 10 percent as the range of reasonableness. A 10 percent range of reasonableness (ROR) was also supported by the ASBCA in the Information Systems & Networks Corporation ASBCA Decision”
 - DCAM also asserts (incorrectly) that the ASBCA decision in “Information Systems & Networks Corporation ASBCA No. 47849 ‘capped’ executive compensation at the 75th percentile when justified by performance”

Compensation - Challenges

- Reasonableness – overall
 - Bonuses
 - Lack of approval from ACO for changes to compensation programs
 - Lack of wage or salary survey to support
- Inconsistency
- Dependent Health Care Costs
- T&M Contracts - Resume and Labor Category requirements

Employee Morale, Health, Welfare, Food Service, and Dormitory Costs and Credits – FAR 31.205-13

- Aggregate costs are allowable:
 - Improve working conditions
 - Improve employee morale
 - Improve employee performance
- Gifts are unallowable – not awards recognizing employee achievements
- Recreation is unallowable – except for sponsored teams or organizations
- FASA imposed significant changes in 1996

Alcoholic Beverages — FAR 31.205-51

- Unallowable
- Company policy is important
- Auditor tactics can be a concern

Travel Costs – FAR 31.205-46

- Travel must be for official business
- Approval expected
- Air Fair limitations - Coach travel and “lowest available fare”
- Per diem vs. Actual costs
- Unallowable Costs
 - Alcohol
 - Travel in excess of FTR daily rate
 - Lowest available airfare

Travel Costs Challenges

- General rule of thumb – *Travel cost should follow the labor cost – [i.e. direct if labor is direct]*
- Lack of receipts
- Reasonableness of cost
- No justification of business purpose
- Partial travel days
- Company policy conflicts

Entertainment Costs — FAR 31.205-14

- Amusement
- Diversions
- Social activities
- Tickets to shows and sporting events
- Membership in social clubs
- All unallowable

Relocation Costs – FAR 31.205-35

- Relocation for assignments of not less than 12 months
- Move must be for the benefit of the employer
- If employee quits within 12 months of relocation - Government entitled to a credit for relocation costs
- Quite comprehensive listing of what is allowable

Trade, Business, Technical and Professional Activity – FAR 31.205-43

- Memberships -- Allowable
- Subscriptions -- Allowable
- Meetings and symposiums where the principal purpose is the dissemination of technical, business or trade information, the stimulation of production, or improved productivity -- Allowable

Training & Education – FAR 31.205-44

- Vocational training - allowable
- Part-time college - fees and straight time not in excess of 156 hours per year
- Full-time - Fees but not salary, if related to employees field, for not more than 2 years
- Specialized training - not more than 16 weeks per year
- Employee Dependents – not allowable

Project Related Costs

- Material Costs
- Rental Costs
- Bonding Costs
- Cost of Money
- Contingencies
- Contract Losses
- Precontract Costs
- Special Tooling and Test Equipment
- Gains and Losses on the Disposition of Depreciable Property or Other Capital Assets

Material Costs - FAR 31.205-26

- Material costs are allowable
- Requires consideration of rebates or credits
- Allows for direct charging if the contract is known at the time of purchase
- Requires the use of GAAP inventory valuation techniques if there is an inventory
- Dictates transfer pricing procedures between related parties
- DCAA guidance on commercial items

Rental Costs - FAR 31.205-36

- Real or personal property operating leases
- FASB 13 – GONE! – Replaced by FASB ASC 840
- Must be reasonable
- Sale - leaseback limited to costs if sale had not occurred
- Related parties limited to cost of ownership unless personal property and established practices similar to unaffiliated lessees
- Potential impact of new lease rules

Bonding - FAR 31.205-4

- Bonding costs arise when a party requires assurance against financial loss to itself or others by reason of the act or default of the contractor.
- Included are such bonds as bid, performance, payment, advance payment, infringement, and fidelity bonds.
- Costs of bonding required pursuant to the terms of the contract are allowable.
- Costs of bonding required by the contractor in the general conduct of its business are allowable to the extent that such bonding is in accordance with sound business practice and the rates and premiums are reasonable under the circumstances.

Contingencies - FAR 31.205-7

- Reasonably foreseeable and can be estimated within reasonable limits of accuracy - allowable
- Otherwise unallowable

Cost of Money - FAR 31.205-10

- A non-cost cost
- Imputed amounts using the Secretary of the Treasury Interest Rate
- Can be waived by the contractor (due to profit implications)
- Treated as an incurred cost for progress payment and public voucher purposes

Contract Losses- FAR 31.205-23

- Loss is defined as cost in excess of revenue [includes cost sharing]
- Losses on contracts are unallowable

Precontract Costs- FAR 31.205-32

- Major red flag!
- Do it in writing!
- Must meet three tests:
 - incurred directly pursuant to negotiations
 - necessary to meet the contract schedule
 - are otherwise allowable
- FAR 31.109 for advance agreement

Special Tooling and Test Equipment- FAR 31.205-40

- Special tooling and test equipment is an allowable direct cost – not indirect cost
- General purpose tooling and test equipment is an allowable indirect cost (depreciation), not direct cost

Gains and Losses on Disposition of Depreciable Property or Other Capital Assets- FAR 31.205-16

- Costs are credited or charged in the year in which they occur to the same cost pool that the depreciation for that asset was charged
- No gain or loss as a result of a business combination
- Limited to the amount of depreciation that was charged
- Impairments – No write-off allowed

Depreciation - FAR 31.205-11

- Systematic and logical assignment of assets to benefitting cost accounting periods
- Reasonable if:
 - consistent with other cost centers
 - reflected in books of accounts and financial statements
 - both used and acceptable for tax purposes
- Acquisitions – No step up, no step down
- Use Charges

Selling and Marketing Costs

- Public Relations and Advertising
- Selling Costs
- IR&D and B&P

Public Relations and Advertising Costs — FAR 31.205-1

- Allowable advertising
 - help wanted
 - acquire materials
 - dispose of scrap
- Allowable public relations
 - required by contract
 - responding to inquiries
 - communicating with public
 - general liaison
 - community services
 - plant tours
 - keel laying

Selling Costs — FAR 31.205-38

- Direct selling costs are allowable if reasonable
- Costs associated with broad marketing efforts to export products purchased by the Government are allowable provided they are reasonable
- Commissions are allowable if paid to bona fide employees or agencies

IR&D and B&P Costs — FAR 31.205-18

- Allowable if reasonable
- IR&D not required to do a contract
- B&P preparing and supporting bids
- Challenging accounting requirements
- Good policies and procedures are critical
- New focus of Pentagon
- Congressional viewpoints

Other Cost Principles

Bad Debts – FAR 31.205-3

- Unallowable
- Directly associated costs – collections, dunning, accounts receivable issues

Contributions or Donations – FAR 31.205-8

- Unallowable
- Cash, property or services
- Does not include FAR 31.205-1(e)(3) for community services like blood drives

Fines, Penalties and Mischarging Costs — FAR 31.205-15

- Fines and penalties are unallowable unless approved by the contracting officer
- Cost of correcting records is unallowable if the reason the records have to be corrected is due to the false or improper recording of cost

Interest and Other Financial Costs— FAR 31.205-20

- Unallowable
- Some recent court cases allow ‘interest’ on state income tax obligations where the contractor was not delinquent or acted reasonably

Lobbying & Political Activity Costs — FAR 31.205-22

- Any activity to influence Executive or Legislative staff is unallowable
- Presentations on factual or technical information about a contract are allowable if supported by documentation
- Requires a certification

Organization Costs — FAR 31.205-27

- Costs for effort affecting the capital structure of the company -- not the weekly reorganizations
- Unallowable
- Lots of confusion and misinterpretation of this principle with merger mania of the 1990's

Other Business Expenses — FAR 31.205-28

- Shareholder meetings, soliciting normal proxy, preparing and publishing reports etcetera, etcetera, etcetera
- Allowable

Patent Costs — FAR 31.205-30

- Only costs required by contract or for general patent advice are allowable
- All other costs are unallowable

Professional and Consultant Service Costs — FAR 31.205-33

- Generally allowable but must be reasonable
- Cannot be officers or employees of the contractor
- Must be supported by:
 - Details of agreement and actual services
 - Invoices with sufficient detail to allow an evaluation of what was done
 - Work product or memorandum of meetings

Recruitment Costs — FAR 31.205-34

- Cost of help wanted, employment office, travel costs, etc.
- Generally allowable
- Ads must be for specific positions required by the contract or be indirect positions
- Must not be public relations type costs

Royalties & Other Costs for Use of Patents — FAR 31.205-37

- Allowable unless:
 - Government owns license or has free use
 - patent adjudicated to be invalid
 - patent is considered to be unenforceable
 - patent has expired
- Warns to be careful regarding reasonableness of less-than-arms-length transactions

Taxes — FAR 31.205-41

- Generally allowable
- Following are unallowable:
 - Federal income and excess profits tax
 - taxes associated with financing activities
 - taxes for which exemptions could have been obtained
 - Special assessments on land that represent capital improvements
 - taxes on real or personal property used only on non-government work
 - Taxes on accumulated funding deficiencies
 - Income tax accruals for timing differences

Termination Costs – FAR 31.205-42

- Common items
- Costs continuing after termination
- Initial costs
- Loss of useful value
- Rental under unexpired leases
- Alterations of leased property
- Settlement costs – Internal and External
- Subcontractor claims
- FAR Part 49

Business Combinations — FAR 31.205-52

- Tangible capital assets
 - Purchase method of accounting
 - If prior depreciation or COM – book value of seller
 - If no prior depreciation or COM – fair value at time of acquisition
- Intangible capital assets
 - Purchase method of accounting – no step up

Final Close-Out

- Final indirect cost rates
- Contract audit closing statement
- Quick close-out procedures (FAR 42.708)
- DCAM suggests that auditors be sensitive to the impact of audits on contractor cash flow (DCAM 6-707.3)

Other Issues

- DCAA Form 1
- Limitations on withholdings
- Payment reductions to off-set contractor debt

When: Incurred Cost Proposals, Rates and Close-Out

- What is an ICP
- DCAA ICE Model
- Audit of ICP
- Close-out



Polling Question

Who is required to submit an ICP?

- a) Any company receiving a federal contract or subcontract
- b) A company awarded a contract with FAR 52.216-7
- c) Any company that receives a request from DCAA for an ICP
- d) A company that has only commercial and fixed price contracts

What is an ICP?

- Per FAR 52.216-7(d) - Allowable Cost and Payment: Final annual indirect cost rates and the appropriate bases shall be established in accordance with Subpart 42.7 of the FAR in effect for the period covered by the indirect cost rate proposal.
- The contractor shall submit an adequate final indirect cost rate proposal (ICP).
- The proposed rates shall be based on the contractor's actual cost experience for that period.

Contract Clauses Driving the Submission

- Clauses commonly found in cost type and time and materials contracts carry compliance risk.
- FAR 52.216-7(d), Allowable Cost and Payment
 - Annual rates and bases “shall be established” based on FAR 42.7
 - “Shall” submit an adequate rate [proposal]
 - Clause ((d)(2)(iii)) includes list of schedules to meet adequacy
- FAR 52.232-7, Payments under Time-and-Materials and Labor-Hour Contracts
 - Labor is excluded from ICP requirement (hours and labor rates)
 - The “M” is auditable
 - Defines material costs (travel, ODCs, materials, subcontracts, indirect)
 - Pass through costs defined by costs accounting practices
- Can be found in prime and subcontracts
 - Read and understand your contract!

Who is exempt from submitting an ICP?

- Commercial contracts
- Labor hour contracts (No “M”)
- Fixed price contracts
- Contracts closed out under the quick close out procedure
 - When conditions under FAR 42.708(a) are satisfied, CO can settle indirect costs in advance of final indirect cost rate

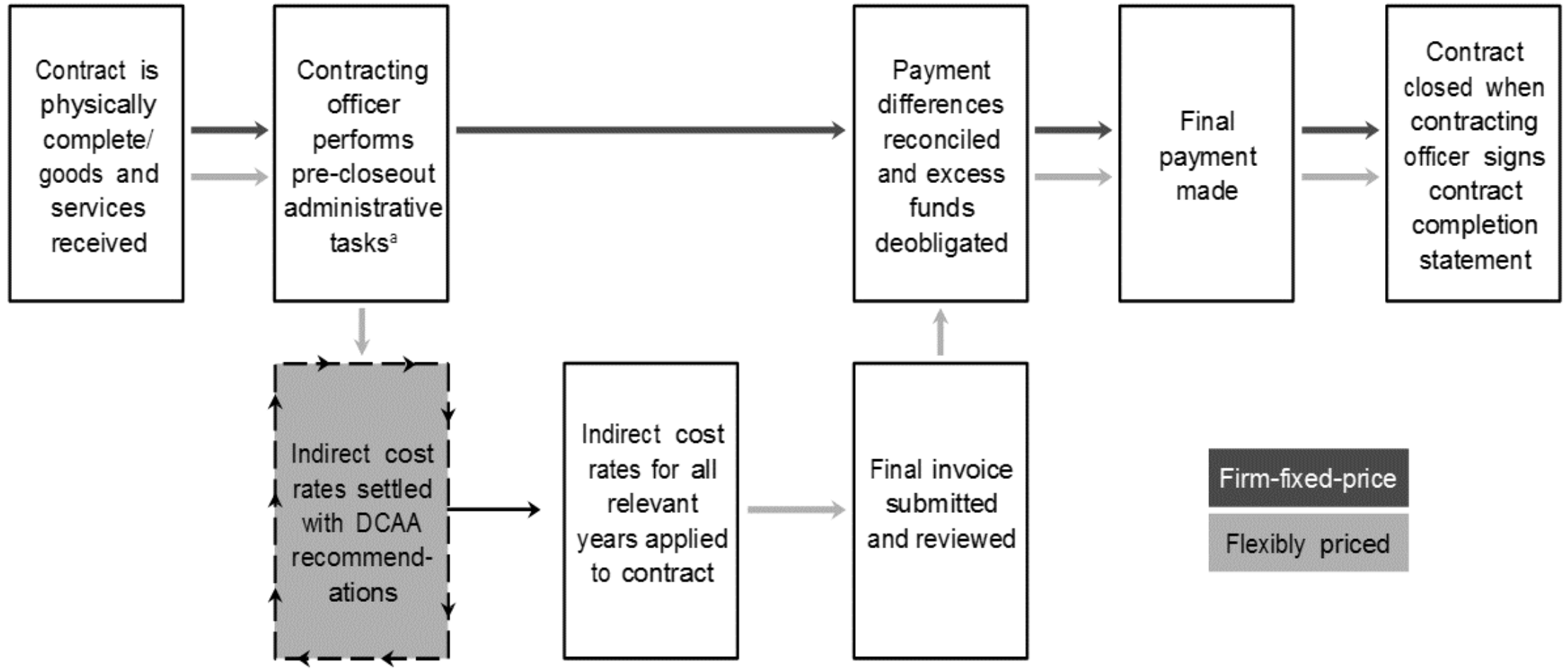
Why must I submit an ICP?

- You must submit an ICP because you signed a contract with the clause that triggers the ICP
- The purpose of the ICP is to “true-up” your provisional rates to actual rates in order to settle up on the amount the Government owes you or the amount you owe the government (Schedule I)

Indirect Rate Cycle – Rate Monitoring

- Rates must be monitored by the contractor and may be adjusted as necessary throughout the year (FAR 42.704(c) and FAR 52.216-7(e))
 - Protects the contractor and the government
 - Review indirect rates on a regular basis
 - Monitoring over/under billings per contract
 - Once material rate variances are evident, submit adjusting invoices timely
 - Ensures payment to the contractor prior to exhausting of funding
 - In current budget environment the contractor is wise to recover actual costs as quickly as possible
 - No cash flow or financial statement surprises if regularly reviewed

Indirect Rate Cycle – Contract Closeout



Where must I submit an ICP?

- To your cognizant DCMA and DCAA representative
 - FAR 52.216-7(d)(1)(2)(i) - The Contractor shall submit an adequate final indirect cost rate proposal to the Contracting Officer (or cognizant Federal agency official) and auditor
 - DCMA points of contact
 - <http://www.dcma.mil/Contact-Us/>
 - DCAA points of contact
 - <http://www.dcaa.mil/home/contactUs>

When must I submit an ICP?

- Six months after the contractor fiscal year end
 - FAR 52.216-7(d)(1)(2)(i) - The Contractor shall submit an adequate final indirect cost rate proposal to the Contracting Officer (or cognizant federal agency official) and auditor within the six-month period following the expiration of each of its fiscal years.
- Extensions
 - Reasonable extensions, for exceptional circumstances only, may be requested in writing by the contractor and granted in writing by the administrative contracting officer.

What if I am late?

- MRD 14-PPD-002(R) 2/3/14
 - DCAA will provide a single late notification letter when an ICP is days overdue
 - Starting in Jan '15, DCAA will send a list annually to the DCMA of late proposals or inadequate proposals
 - DCMA has the option to 1) get adequate proposals or 2) unilaterally establish rates per FAR 42.703-2(c)(1) & 42.705(c)(1) with the option of a unilateral cost decrement
- MRD 14-PPD-002(R) 2/11/16
 - DCMA can unilaterally decrement your rates if adequate submissions are not submitted timely
 - The current rate, updated in 2016, is 16.4 percent, based on an agency-wide analysis (to be updated “every three years”)

ICP Project Management

- Establish a project plan for the preparation of your ICP
- Identification of milestone projects (i.e., each ICP schedule)
- Identification of key parts of each ICP Schedule and responsible parties
- Milestone dates (beginning and end) for reviewing and completing each project/schedule and for final review and submission of the ICP
- This webinar should help you get started in preparing your ICP
- Please contact us on detailed questions you may have on certain schedules or any other aspects of the ICP

Polling Question

If required, how long after a reporting period ends, does a contractor have to submit an ICP?

- a) 1 month
- b) 2 months
- c) 6 months
- d) 1 year
- e) Unlimited

DCAA ICE Model

- ICE Model (Incurred Cost Electronically)
 - Revised Version 2.0.1h (released April 2018)
 - [https://www.dcaa.mil/Home/ICEmodel?title=ICE%20\(Incurred%20Cost%20Electronically\)%20Model](https://www.dcaa.mil/Home/ICEmodel?title=ICE%20(Incurred%20Cost%20Electronically)%20Model)
 - The ICE model is intended to aid the contractor in providing an adequate submission to DCAA, its use does not guarantee that the submission will be judged adequate.
- Use of the ICE model is not mandatory.
- Contractors may develop their own template for submission however they must contain the required data described in FAR 52.216-7 (d)(2)(iii) - Allowable Cost and Payment.

DCAA ICE Model (continued)

- The ICE model can be tailored to match the indirect rate structure of the contractor
- Tabs and formulas are linked so care should be taken to avoid breaking links and formulas
- Upon completion all should links and formulas should be double checked
- Not all schedules are mandatory schedules

ICP Schedules “A” through “J”

- Schedules A-G
 - Trial balance and general ledger detail
 - Statement of indirect expenses/indirect rate calculation
- Schedule H
 - Job/project summary reports (at the billing level)
 - For government cost reimbursable and T&M
 - Contract briefs/whether the contract is a DoD or non-DoD prime or subcontract
- Schedule I
 - Contract revenue by contract type and contract ceiling amounts
 - Is contract physically complete in the FY of the ICP?
 - Is contract subject to the penalty clause FAR 52.242-3?
- Schedule J
 - Point of contact information and other contract detail including costs incurred for flexibly priced subcontracts

ICP Schedules “K” through “O”

- Schedule K
 - Final year-end invoices with cumulative amounts billed for T&M contracts including rates and hours billed by labor category
- Schedule L
 - Payroll reconciliation
 - Year-end payroll summary report
 - 941 quarterly tax filings
- Schedule M
 - Listing of decisions, agreements, approvals and description of accounting/organizational changes
- Schedule O
 - Is contract physically complete in the FY of the ICP?
 - Actual hours incurred for physically complete contracts
 - Contract fee computations, period of performance and contract ceiling amounts

ICP Evaluation Timeline

- Contractor submission of ICP
- DCAA performs adequacy check
- DCAA informs contractor of ICP adequacy or inadequacy
 - In the event of an inadequate submission the Contractor may correct and resubmit
- DCAA risk assessment and audit selection
 - ICP is selected for audit OR
 - ICP is dispositioned with a memorandum to the CO

DCAA Adequacy Checklist

- MRD August 27, 2015 – 15-PPD-005(R) - Revised Checklist for Determining Adequacy of Contractor Incurred Cost Proposal
- Contractors were often concerned that DCAA performs audit steps in the adequacy review process only to perform them again during audit, doubling the effort on contractors
- DCAA deleted some checklist items which were not critical to determine adequacy and expanded some sections related to completeness and the overall function and tie-out of the ICP.
- DCAA has also reinforced its position that auditors use professional judgment when making an inadequacy determination and obligates them to document and defend an inadequacy determination
- May result in less duplicative effort by contractors and fewer inadequacy determinations

DCAA Risk Assessment/Auditing Sampling

<u>Risk Category</u>	<u>Sampling ADV</u>	<u>Sampling Percentage</u>	<u>Notes</u>
Low	<\$5M	0.5%	
	\$5M - <\$50M	5%	
	\$50M - <\$100M	10%	
Medium	\$100M - \$250M	20%	Mandatory audit every 5 th year.
	>\$250M - \$500M	25%	Mandatory audit every 4 th year.
High	>\$500M - <\$1B	25%	Mandatory audit every other year.
	\$1B or more	N/A	Audit must be performed each year.

Statute of Limitations (SOL)

- In 1994, Federal Acquisition Streamlining Act (FASA) established a six-year SOL – FAR 33.206
 - The CO shall issue a written decision on any government claim initiated against a contractor within 6 years after accrual of the claim, unless the parties agreed to a shorter time period
 - Does not apply to fraud cases
 - Accrual of a claim = the date when all events, that fix the alleged liability of either the government or the contractor and permit assertion of the claim, were known or should have been known
 - Fix the liability = some injury must have occurred (financial or otherwise)
 - Recent court cases demonstrate the SOL is being tested at phases throughout the contract life cycle (Boeing, Raytheon, Alion)
 - The date of submission rather than the date of audit starts the SOL clock (date when claims were known or should have been known) however this is being tested in the courts

Backlog Influence on DCAA and Contractors

- The ICP backlog could cause some ICP years to go unaudited after the expiration of the SOL
- DCAA is aggressively targeting ICP backlog to minimize SOL issues
 - This could influence the DCAA to find a contractors ICP inadequate even at the last minute and force them to update and recertify which would reset the six year SOL clock
 - Contractors should not recertify unless there is a change in their indirect rates
- Some contractors have taken bold steps on unaudited ICP over six years old, like:
 - Notifying DCAA they have 30 days to take what ever action on the old ICP, and then records will be destroyed
 - Refused DCAA access to records on ICP, saying the ICP are no longer subject to audit
- Consult with your legal and other advisors before taking “bold” steps

2018 National Defense Authorization Act

- Section 803, Performance of Incurred Cost Audits
 - provides that DoD shall eliminate, by October 1, 2020 any backlog of ICP audits and
 - Includes new ICP timeliness requirements which have been implemented and incorporated into DCAA's Contract Audit Manual.
 - The new requirements include:
 - a DCAA adequacy review and notification of the results within 60 days of submission and
 - completion of ICP audits within one year of a qualified submission.
 - Tight timeline may result in DCAA utilizing a risk-based approach for audit selection, excluding more ICP from audit than in previous years.
 - For contractors with a June 30th 2018 ICP deadline, it could be advantageous for you to submit an adequate ICP in a timely manner to be included in the largest pool of submissions that must meet the new turnaround times.

Polling Question

When should a contractor prepare for audit?

- a) Once notified by DCAA of audit
- b) During preparation of the ICP
- c) After audit begins
- d) All of the above
- e) Prepare? Let's wing it!

Prior to Audit

- During ICP preparation, create an audit package with all ICP supporting schedules and backup documentation as an audit may not occur for many years
- Document any assumptions or management decisions that are not clear from the supporting schedules as the ICP preparer may no longer be with your company
- Perform DCAA Adequacy checklist and retain with documentation

Prior to Audit- Frequently Asked Questions

- Review the submission and ensure the reasonableness and adequate support of frequently questioned costs:
 - Compensation (not only executive compensation)
 - Document reasonableness
 - \$952k vs \$487k vs \$525k
 - Bonus
 - Employee morale
 - Travel and entertainment
 - Marketing
 - Legal
 - Subcontract costs
 - Poor SOW documentation
 - Direct labor
 - Labor qualifications for T&M contracts (5-22-14 audit alert)
 - Labor categories and resumes
 - Labor Hours - timekeeping system
 - Lack of timesheets/inadequate approvals

At the Time of Audit

- Compile the audit package and have the backup data available in hard copy and electronic format
- Establish a single point of contact for all communication and flow of documentation with the auditor
- Request a walkthrough of the audit
- Conduct periodic updates on the progress of the audit and any open items.
- Be familiar with DCAA Audit procedures
 - Contract Audit Manual (CAM) Chapter 6 ICP Audit Procedures

Polling Question

How long does DCAA have to audit my ICP?

- a) 1 month after adequate submission
- b) 60 days after adequate submission
- c) 1 year after adequate submission
- d) Unlimited
- e) 10 years after adequate submission

What is a Contract Close-Out?

- This is an administrative process
 - Begins after contract is physically complete
 - All products delivered, inspected and accepted
 - All services performed and accepted
- Contract closeout occurs when a contract has met all the terms of a contract and all administrative actions:
 - Have been completed (i.e., property, security, patents, and royalties)
 - All disputes have been settled
 - Final payment has been made
- Procedures – standard or quick closeout

Contract Closeout

- Closeout of contract files
 - Closeout by Procuring Contracting Officer (PCO)
 - Closeout by Administrative Contracting Officer (ACO)
 - Closeout by paying office
 - Physically completed contracts
 - Procedures for closing out files
- Time standards:
 - Simplified Acquisition – Closed when completed
 - Firm fixed price – within 6 months
 - Contracts requiring indirect cost rates – 36 months
 - All other contracts – 20 months
- Do not Closeout:
 - Contracts in litigation or under appeal
 - Terminated contracts where actions are open

FAR 4.804-5 Closeout Procedures

- Review contract fund status
- 15 point checklist for close-out – DD Form 1597
- Prepare contract completion statement
 - Communication with Customer

15 Points for Close Out

- 1) Disposition of classified material is completed
- 2) If a final patent report is required, may proceed with contract closeout.
- 3) Final royalty report is cleared
- 4) There is no outstanding value engineering change proposal
- 5) Plant clearance report is received
- 6) Property clearance is received
- 7) All interim or disallowed costs are settled
- 8) Price revision is completed
- 9) Subcontracts are settled by the prime contractor
- 10) Prior year indirect cost rates are settled
- 11) Termination docket is completed
- 12) Contract audit is completed
- 13) Contractor's closing statement is completed
- 14) Contractor's final invoice has been submitted
- 15) Contract funds review is completed and deobligation of excess funds occurs

Thank you and time
for questions . . .



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