

Cost-Plus Contract Management

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Your Instructors



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Agenda

- Introduction
- Major Government Players in the Cost-Plus World
- Accounting Systems
- Audit Process
- Disallowance Process
- Allowability
- Allocability
- Reasonableness
- Truthful Cost and Pricing Act
- Questions?

Introduction: What is a Cost-Reimbursement Contract?

- Provides for the payment to contractor of allowable incurred costs to the extent provided in contract
 - Most cost risk borne by Government, unlike Firm Fixed Price (FFP) Contract
 - Limitation of Cost (FAR 52.232-20):
 - Government – not obligated to reimburse contractor for costs incurred above estimated cost in Schedule
 - Contractor – not obligated to incur costs above estimated cost in Schedule absent an increase of estimated cost from the Contracting Officer (CO)
- **When?** FFP contract impractical (FAR 16.301-2)
 1. Agency unable to sufficiently define requirements for FFP
 2. Uncertainties involved in contract performance prohibits costs from being estimated with sufficient accuracy

Introduction: Types of Cost-Plus Contracts

1. Cost-plus-incentive-fee

- Initially negotiated fee, adjusted later by a formula based on the relationship of total allowable costs to total target costs (FAR 16.304)

2. Cost-plus-award-fee

- Provides for a fee consisting of: **(a)** a base amount, fixed at inception of contract (may be \$0) **and (b)** an award amount, based upon a judgmental evaluation by Government, sufficient to provide motivation for excellence in contract performance (FAR 16.305)

3. Cost-plus-fixed-fee

- Negotiated fee, fixed at inception of contract (FAR 16.306)

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



Major Government Players in the Cost-Plus World

- Procuring Contracting Officer (PCO)
 - Solicitations
 - Certified Cost or Pricing Data
 - Sources
 - Contracts and Modifications
 - Defective Pricing and Direct Cost Issues
- Administrative Contracting Officer (ACO)
 - Contract Administration Functions – forward pricing rate agreements, advance agreements, allowable costs, disputes, progress payments, and cost overruns
- Defense Contract Audit Agency (DCAA)
 - Contract Auditing for Department of Defense
 - Accounting and Financial Advisory Services for DOD with negotiating, administering, and settling contracts and subcontracts



Accounting Systems: Basic Requirements

- For cost-reimbursement contract – contractor **must** have accounting system adequate for determining costs applicable to contract or order (FAR 16.301-3)
- Contractor Responsibilities (FAR 31.201-2):
 - Appropriately account for costs
 - Maintain records, including adequate supporting documentation – demonstrate costs claimed have been incurred, allocable to contract, and comply with applicable cost principles
- Why?
 - Government may disallow all or part of a claimed cost that is inadequately supported

Accounting Systems: Accounting for Unallowable Costs

- **Contractor Responsibility:** Identify and exclude from *any* billing, claim, or proposal costs **expressly unallowable** or mutually agreed to be unallowable, including directly associated costs (FAR 31.201-6 and CAS 405)
 - **Expressly unallowable cost:** Item or type of cost specifically named and stated to be unallowable, under applicable law, regulation, or contract
 - **Directly associated cost:** Cost generated solely as a result of the incurrence of another cost that would not have been incurred had other cost not been incurred
- **Why? Penalties**
 - Inclusion of expressly unallowable indirect costs in final indirect cost proposals for contracts in excess of \$800,000 subjects contractor to a penalty equal to **(a)** amount of disallowed costs allocated to contract plus **(b)** interest on paid portion of disallowance (FAR 42.709-2)
 - If determined to be unallowable before proposal submission, **penalty doubles**
 - Possible even if Government reimbursed costs

Accounting Systems: Form

- Accounting System must comply with 18 criteria to be “acceptable accounting system,” including (DFARS 252.242-7006) –
 - Sound internal control environment, accounting framework, and organizational structure
 - Segregation of direct from indirect costs
 - Identification and accumulation of direct costs by contract
- Contractors with cost-reimbursement contracts exceeding \$250,000 not for the acquisition of commercial products or commercial services:
 - **Material Management and Accounting System (MMAS)** must comply with 10 criteria to be “acceptable MMAS,” including (DFARS 252.242-7004) –
 - Adequate system description, with policies, procedures, and operating instructions that comply with FAR and DFARS
 - Audit trails and records necessary to evaluate system logic and verify system operates as desired
 - Adequate levels of record accuracy and include reconciliation of recorded inventory quantities to physical inventory
- DCAA Contract Audit Manual (DCAM) Chapter 5 – additional guidance

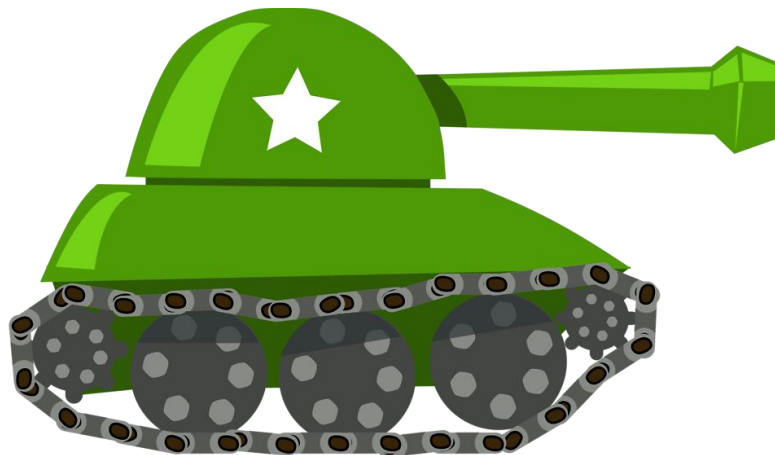
Polling Question

The Army has a requirement for a major weapon system. Due to the complexity of the requirement and the level of innovation required, the Army is unable to define its requirement with enough detail in advance of the procurement, and due to uncertainties in the supply chain, particularly with long-lead items, the Army cannot accurately estimate how much the requirement will cost. What contracting vehicle would be appropriate to this procurement?

- A. Firm-fixed price contract
- B. Cost-plus-incentive-fee contract
- C. Cost-plus-a-percentage-of-cost contract
- D. All of the above
- E. None of the above

And the Correct Answer is...B!

- FFP would be inappropriate because (1) circumstances do not allow the Army to define its requirement sufficiently to allow for FFP contract and (2) uncertainties involved in contract performance do not permit costs to be estimated with sufficient accuracy to use any type of FFP contract
- Cost-plus-a-percentage-of-cost contracts are **expressly prohibited** by the FAR
 - Otherwise, contractors would have no incentive to control costs
- Cost-plus-incentive-fee contract would allow for reimbursement of costs while also incentivizing the contractor to keep incurred costs as close to targets as possible



Audit Process: Record Retention

- **Contractor Responsibilities:**

- Maintain all records and other evidence sufficient to reflect properly all costs claimed to have incurred or anticipated to be incurred, directly or indirectly in performance of contract (FAR 52.215-2)
- Retain and make available records for 3 years after final payment (FAR 4.703) *or* as otherwise required (FAR 4.705 through 4.705-3)

- **CO Right:** Examine and audit all records and other evidence



Audit Process: Types of Audits and the Audit Report

- **Common Types of Audits:**

- **Business Systems & Subsystems Audit:** Evaluation of contractor's internal controls and assessment of control risk (occurs once every 4 years) (DCAM Chapter 5)
- **Incurred Costs Audit:** Examination of contractor's cost representations, in whatever form they may be presented, to determine whether such incurred costs are reasonable, allowable, and applicable to the contract as determined under GAAP and CAS applicable in the circumstances, and not prohibited by the contract, by statute or regulation, or by previous agreement with, or decision of, the Contracting Officer (DCAM Chapter 6)
- **Audit of Cost Estimates and Price Proposals:** Evaluation of estimates of cost and profit supporting price proposals submitted by contractor in connection with award, administration, modification, or repricing of Government contracts (DCAM Chapter 9)

Audit Process: The Audit Report

- Principal means of conveying DCAA's audit results to COs and other interested parties (DCAM 10-102)
- Only advisory **but** COs typically rely heavily upon DCAA audit reports when deciding cost and pricing issues



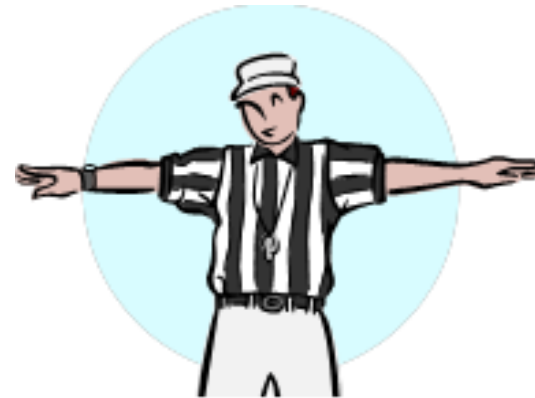
Disallowance Process

- **FAR 52.242-1 Notice of Intent to Disallow Costs:** Contracting Officer may at any time issue to contractor a written notice of intent to disallow specified costs incurred or planned for incurrence that have been determined not to be allowable
 - Upon receipt, contractor may submit a written response within 60 days to Contracting Officer, with justification for allowance of the costs
 - If contractor submits written response, Contracting Officer shall within 60 days make a written withdrawal of the notice or issue a written decision
 - Failure to issue Notice of Intent does not affect Government's right to take exception to incurred costs



Disallowance of Costs after Incurrence

- If examination of a voucher raises a question regarding allowability, an authorized auditor may issue a notice of contract costs suspended and/or disapproved for deduction from current payments with respect to costs claimed but not considered reimbursable (FAR 42.803)
 - For DOD contracts, notice is contained on DCAA Form 1
 - If contractor disagrees with deduction, contractor may:
 - (1) Submit a written request to the Contracting Officer to consider whether unreimbursed costs should be paid and to discuss findings with the contractor
 - (2) File a claim under the Disputes clause
 - (3) Do both of the above



Allowability

A cost is allowable only if it complies with all of the following requirements (FAR 31.201-2):

- (1) Reasonableness;
- (2) Allocability;
- (3) The CAS, if applicable, GAAP and practices appropriate to the circumstances;
- (4) Terms of the contract; and
- (5) Any limitations set forth in the Cost Principles

The Cost Principles

- FAR Subpart 31.205 contains Cost Principles for **46** selected items of cost
 - **But** the absence of a Cost Principle for a particular item does not imply that the cost is either allowable or unallowable
 - In the absence of a specific Cost Principle, the determination of allowability shall be based on principles and standards in the Cost Principles and **the treatment of similar or related selected items**
 - When more than one Cost Principle is relevant to a contractor cost, the cost shall be apportioned among the applicable subsections, and the determination of allowability of each portion shall be based on the guidance contained in the applicable subsection
 - When a cost, to which more than one Cost Principle is relevant, cannot be apportioned, the determination of allowability shall be based on the guidance contained in the subsection that most specifically deals with, or best captures, the **essential nature** of, the cost at issue

Allowability – Selected Cost Principles

Generally Allowable

- Employee Morale, Health, Welfare, Food Service, and Dormitory Costs and Credits
 - Losses from operating food and dormitory services
- Compensation for Personal Services (cap and exceptions)
 - Severance, Fringe Benefits, Pension Costs, Postretirement Benefits
- Economic Planning Costs
- Travel Costs (exception)
- Costs Related to Legal or Other Proceedings (cap and exceptions)

Generally Unallowable

- Costs of Alcoholic Beverages
- Entertainment Costs
- Employee Gifts
- Back Pay
- Organization Costs
- Interest and Other Financial Costs (exception)

Allowability – Selected Cost Principles

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

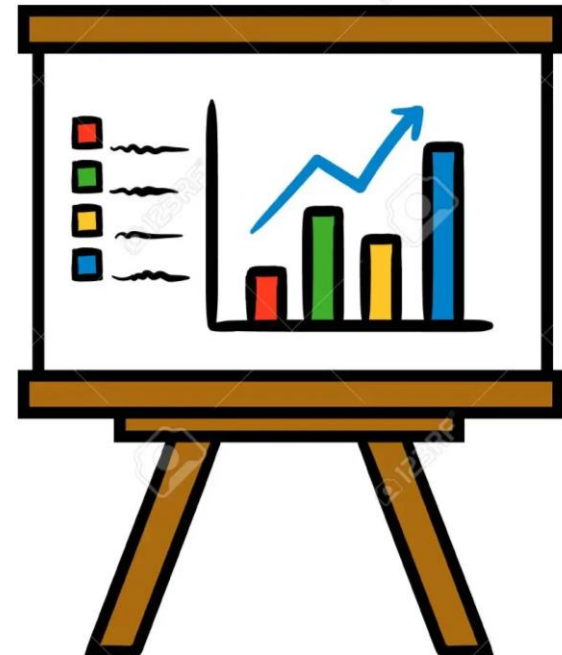
Allowability – Selected Cost Principles

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

Allowability – Selected Cost Principles

- **Economic Planning Costs: Allowable** (FAR 31.205-12)
 - Costs of general long-range management planning concerned with future overall development of contractor's business and that may take into account eventual possibility of economic dislocations or fundamental alterations in those markets in which contractor currently does business

DO NOT include "Organization Costs"



Allowability – Selected Cost Principles

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

Allowability – Selected Cost Principles

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



Allowability – Selected Cost Principles

- **Travel Costs: Allowable**, with limitations (FAR 31.205-46)
 - Costs for transportation, lodging, meals, and incidental expenses are generally **allowable if** incurred by contractor personnel on official company business
 - Airfare costs in excess of lowest priced airfare available to contractor during normal business hours are **unallowable**, except in limited circumstances
 - Applies to costs of travel by contractor-owned, -leased, or -chartered aircraft
 - Costs of contractor-owned or -lease automobiles are **allowable if** reasonable to extent automobiles are used for company business

Allowability – Selected Cost Principles

- **Costs Related to Legal or Other Proceedings: Allowable**, with limitations (FAR 31.205-47)
 - **Unallowable** legal costs are incurred –
 - When result is criminal conviction
 - When result is civil liability for fraud or similar misconduct
 - When result is debarment, suspension, rescission or avoidance of contract, or termination of contract for default because of violation of law or regulation
 - **Allowable** costs capped at 80% if contractor prevails in litigation
 - Settlement costs of actions commenced by US that could have resulted in unallowable circumstances *only allowable* to extent specifically provided in settlement agreement
 - Other **unallowable** legal costs include: **(a)** claims and appeals by and against Government, **(b)** bid protests, and **(c)** defense of antitrust suits
 - Otherwise, legal costs are **allowable** *if* they are:
 1. Reasonable;
 2. Not otherwise recovered from the Government or a third party; and
 3. Percentage of costs allowed does not exceed percentage determined to be appropriate (80% cap)

Polling Question

Contractor was awarded a FFP level-of-effort developmental task order by the Army, for which the Army was required to perform a cost analysis. During the course of performance, the parties modified the task order to a pure FFP contract, and in doing so, the Army again performed a cost analysis. Neither the pre-modification or post-modification task order incorporated the Cost Principles. Also during the course of performance, a *qui tam* relator filed a False Claims Act lawsuit against Contractor, which Contractor successfully defended. Having prevailed in the FCA litigation, Contractor submits a certified claim to recover its legal costs incurred in defending the FCA lawsuit before the modification took effect. Are the Contractor's legal costs recoverable?

- A. No, because the task order was not cost-reimbursable
- B. No, because the task order did not incorporate the Cost Principles
- C. No, because legal costs for defending an FCA lawsuit are always unallowable
- D. Yes, provided requirements of FAR 31.205-47 are satisfied

And the Correct Answer is...D!

- FAR 31.103(a) requires that the Cost Principles and FAR Part 31 shall be used in pricing developmental contracts **whenever cost analysis is performed**
 - Pre-modification task order was LOE developmental and required a cost analysis to be performed
 - Even if task order was always a pure FFP contract, FAR 31.102 requires FAR Part 31 shall be used in pricing FFP contracts whenever a cost analysis is performed
- Even though task order did not incorporate Cost Principles, they were incorporated under the *Christian* doctrine because **(a)** they were mandatory and **(b)** they are deeply ingrained in procurement policy as indicated by decades of their implementation in the regulatory framework of federal procurement
- Costs incurred in connection with any proceeding brought by a third party in the name of the US under the FCA are **allowable** provided requirements of FAR 31.205-47 are met (e.g., no criminal conviction, no fraud, reasonable, 80% cap, etc.)



Allocability – Definitions

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

Allocability – Cost Accounting Standards

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

Allocability – Allocation of Direct & Indirect Costs

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

Reasonableness

- Cost reasonable if nature and amount doesn't exceed what would be incurred by prudent person in competitive business (FAR 31.201-3)
- Burden of proof is on contractor to establish cost is reasonable
- Factors:
 1. Type of cost generally recognized as ordinary and necessary for conduct of contractor's business or contract performance;
 2. Generally accepted sound business practices arm's-length bargaining, and laws and regulations;
 3. Contractor's responsibilities to the Government, other customers, owners of the business, employees, and public at large; *and*
 4. Significant deviations from contractor's established practices



Truthful Cost and Pricing Act

(previously Truth in Negotiations Act (TINA))

- **Contractor Responsibility:** Submit certified cost or pricing data
 - **Cost or pricing data:** All facts prudent buyers and sellers would reasonably expect to significantly affect price negotiations (FAR 2.101)
 - **Certification:** To best of knowledge and belief, cost or pricing data are accurate, complete, and current as of applicable date
- **When?**
 - Contracts exceeding \$750,000, awarded before July 1, 2018
 - Contracts exceeding \$2 million, awarded on/after July 1, 2018
 - Exceptions:
 1. CO determines prices agreed upon are based upon adequate price competition;
 2. CO determines prices agreed upon are based on prices set by law or regulation;
 3. Contract action for commercial items;
 4. Waiver granted
- **Contracts under threshold:** certified cost or pricing data not required, *but* CO may request contractor to submit **data other than certified cost or pricing data** to extent necessary to determine fair and reasonable price (FAR 15.403-3)

Questions?



Thank You!



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