



**FORVIS**

# GovCon 101: Cost Type Contracting

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# Your Instructor



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# Agenda

- What is a Cost Type Contract?
- Evaluating Proposals
- Performance & Administration
- ACOs and Auditors
- Getting Paid, Cost Accounting Requirements

# WHAT IS A COST TYPE CONTRACT?

# What is a Cost Type Contract?

- Pricing Method?
  - Market Based Pricing
  - Cost Justified Pricing
- Contract Type?
  - Cost Reimbursement family
  - Fixed Price family

# Pricing Methods

- Market Based Pricing
  - Competition
  - Commercial Products and Services
- Cost Justified Pricing
  - Allowable Cost
  - Profit / Fee



# Contract Type Characteristics:

	<b>Cost Reimbursement</b>	<b>Fixed Price</b>
Promise	Best Efforts	Must Deliver
Contractor Risk	Low	High
Government Risk	High	Low
Financing	Cost as Incurred	% of actual cost
Administration	Maximum	Minimum
Fee vs. Profit	Fee	Profit

# 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



# 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
- Late 2010's – Reinvigorated emphasis on preference for fixed-price contracts – Regulatory preference established in 2017 NDAA
- 2022 – Preference repealed

# 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)

# EVALUATING PROPOSALS

# Pricing Tools

- The CO is responsible for evaluating the reasonableness of offered prices
- Proposal analysis techniques (FAR 15.404-1)
  - Price Analysis - used when certified cost or pricing data are not required
  - Cost Analysis:
    - Must be used to evaluate the reasonableness of individual cost elements when certified cost or pricing data are required.
    - May be used to evaluate data other than certified cost or pricing data to determine cost reasonableness or cost realism when a fair and reasonable price cannot be determined through price analysis alone.
    - Price analysis should be used to verify that the overall price offered is fair and reasonable.
  - Cost Realism Analysis

# Price Analysis

- Price analysis is the process of examining and evaluating a proposed price without evaluating its separate cost elements and proposed profit.
- Price analysis may include evaluating data other than certified cost or pricing data
- The Government may use many different types of price analysis techniques and procedures to ensure a fair and reasonable price. Most are comparison of proposed prices to:
  - Other proposed prices received in response to the solicitation
    - *Normally, adequate price competition establishes a fair and reasonable prices*
  - Historical prices paid
  - Competitive published price lists, published market prices of commodities, similar indexes, and discount or rebate arrangements
  - Independent Government cost estimates
  - Prices obtained through market research for the same or similar items

# Cost Analysis

- Cost analysis is the review and evaluation of any separate cost elements and profit or fee
- Used to determine a fair and reasonable price or to determine cost realism
- The Government may use various cost analysis techniques and procedures to ensure a fair and reasonable price
- Includes verification that the proposed cost is in accordance with FAR Part 31 and the Cost Accounting Standards when applicable

# Cost Realism

- 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
- Required on cost-reimbursement contracts to determine the probable cost of performance
- Probable Cost vs. Proposed Cost
- May be used on:
  - Competitive fixed-price incentive contracts, or
  - In exceptional cases, on other competitive fixed-price-type contracts



# PERFORMANCE & ADMINISTRATION

# Administration of the Cost-Reimbursement Contract

- Accounting System
- Inspection and Defects
- Terminations
- Property

# 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

# 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

# Convenience Termination

- Settlement provisions
  - All allowable costs within funding
  - Subcontractor settlement costs
  - Settlement proposal costs
  - Storage, transportation, costs, and so on
  - Fee equal to percentage completion

# Default Termination

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



# GETTING PAID, COST ACCOUNTING REQUIREMENTS

25

# 52.216-7 – Allowable Cost and Payment

- 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

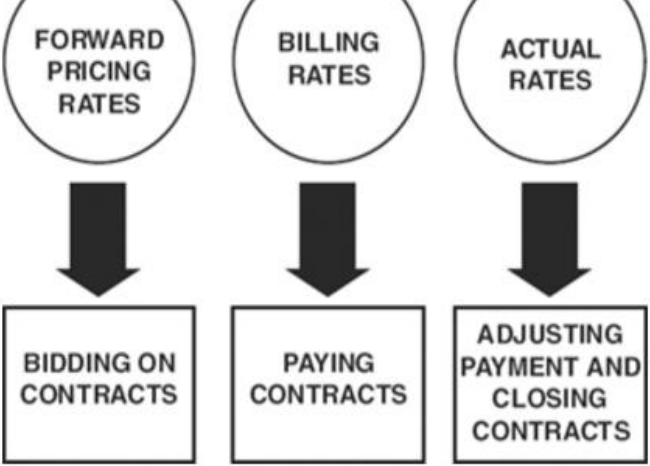
- Cost Principles – FAR Part 31
  - Determination of total cost
  - Allocation of costs as direct or indirect
  - Determination of cost allowability
- Cost Accounting Standards 48 CFR Part 99
  - Small businesses are exempt
  - Consistency requirement for cost accounting practices used for estimating,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

# Direct & Indirect Costs

- A direct cost can be specifically identified with a particular final cost objective.
  - Similar costs incurred for the same purpose must also be a direct cost.
  - Insignificant direct costs can be treated as indirect costs
- An indirect cost is cost not directly identified with a single final cost objective. Left over after all direct costs are assigned.
  - Includes overhead and G&A
  - 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.

# 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 Submission (ICS) submittal, and when the ICS is settled.
  - Submit revised rates if there is a material difference throughout contract
  - Submit final rates in ICS
  - Settle final rates at contract closeout
- 
- ```
graph TD; A((FORWARD PRICING RATES)) --> B[BIDDING ON CONTRACTS]; C((BILLING RATES)) --> D[PAYING CONTRACTS]; E((ACTUAL RATES)) --> F[ADJUSTING PAYMENT AND CLOSING CONTRACTS];
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- ICS rates are comprised of costs which are allocable, reasonable, and allowable on Government contracts.

# Cost Allowability – FAR 31.201-2

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



# 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

# 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.

# 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

# ACOS, AUDITORS AND FAR PART 42

# FAR Part 42

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



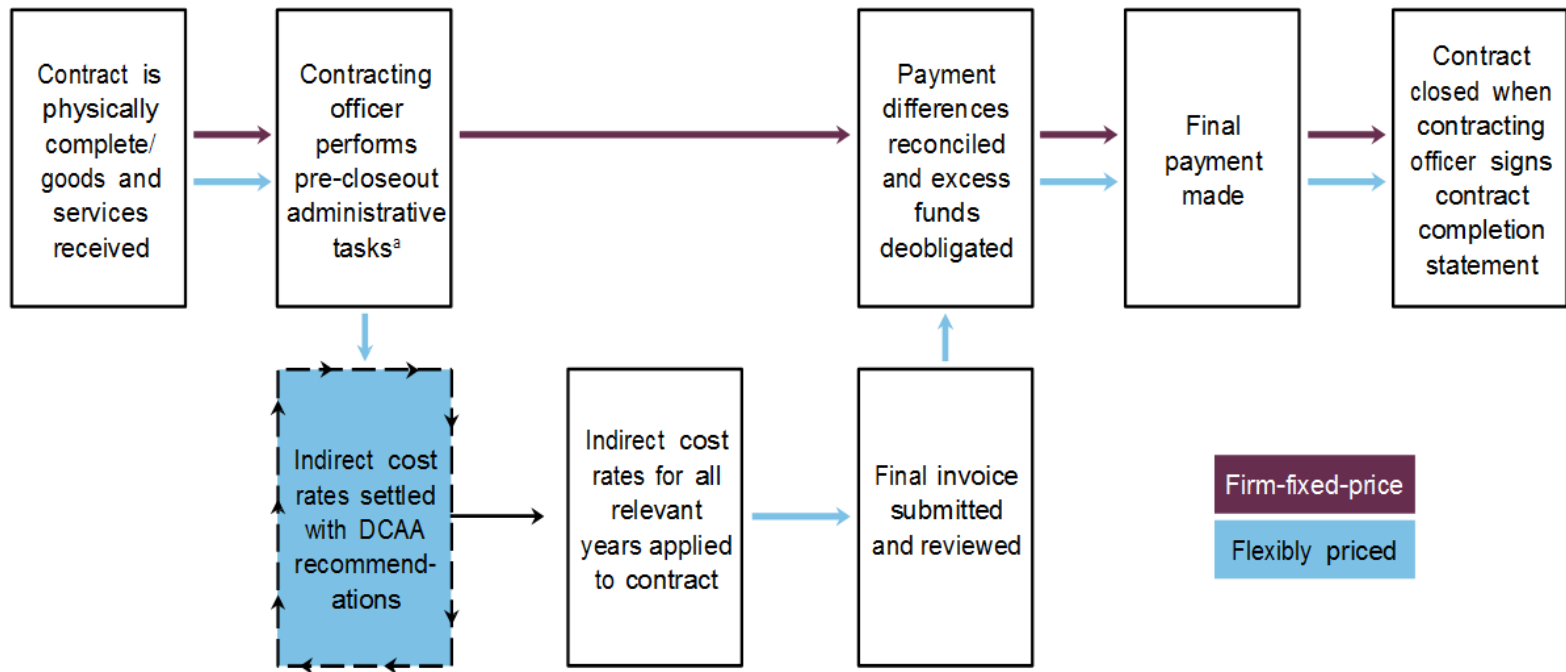
# Incurred Cost Submissions

- 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.
- The proposed rates shall be based on the contractor's actual cost experience for that period.

# Who is exempt from an ICS?

- 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

# Indirect Rate Cycle - Contract Closeout



# Polling Question #1

- All contracts awarded by the federal government are cost type contracts:
  - True
  - False
  - Is this a trick question?

# Polling Question #2

What type of contract provides the greatest risk to the government and also has significant administration requirements:

- a) Cost Reimbursement contract
- b) Fixed Price contract
- c) Indefinite Delivery / Indefinite Quantity contract
- d) Letter contract

## Polling Question #3

Which Pricing Tool is generally required under Cost Type Contracting?

- a) Price Analysis
- b) Cost Analysis
- c) Cost Realism
- d) None of the above

# Polling Question #4

Which administrative requirements are different for cost reimbursement vs. fixed price contracts:

- a) Quality Assurance
- b) Government Property
- c) Default Termination
- d) Termination for Convenience
- e) All of the above

# Polling Question #5

Cost Allowability is governed by:

- a) FAR Part 42
- b) FAR Part 15
- c) FAR Part 31
- d) Cost Accounting Standards



# REVIEW





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