

PRATT'S GOVERNMENT CONTRACTING LAW REPORT

VOLUME 9

NUMBER 12

DECEMBER 2023

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Library of Congress Card Number:

ISBN: 978-1-6328-2705-0 (print)

ISSN: 2688-7290

Cite this publication as:

[author name], [article title], [vol. no.] PRATT’S GOVERNMENT CONTRACTING LAW REPORT [page number] (LexisNexis A.S. Pratt).

Michelle E. Litteken, GAO Holds NASA Exceeded Its Discretion in Protest of FSS Task Order, 1 PRATT’S GOVERNMENT CONTRACTING LAW REPORT 30 (LexisNexis A.S. Pratt)

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POSTMASTER: Send address changes to *Pratt's Government Contracting Law Report*, LexisNexis Matthew Bender, 230 Park Ave. 7th Floor, New York NY 10169.

The Cost Corner

Government Contracts Cost and Pricing: Introduction to the Federal Acquisition Regulation Cost Principles (Part 1)

*By Keith Szeliga and Daniel Alvarado**

Welcome back to the Cost Corner, where we provide practical insight into the complex cost and pricing requirements that apply to government contractors. The Cost Corner previously introduced the three principle categories of government contracts cost and pricing requirements: (1) the Truthful Cost or Pricing Data Statute, also known as the Truth in Negotiations Act (TINA), which defines a contractor's obligation to disclose cost or pricing data to the government; (2) the Federal Acquisition Regulation (FAR) Cost Principles, which prescribe principles and procedures for determining the allowability of costs; and (3) the Cost Accounting Standards (CAS), which provide standards to ensure uniformity and consistency in the measurement, assignment, and allocation of costs. Last month's Cost Corner concluded a three-part series on TINA. This column now moves to the FAR Cost Principles, specifically FAR Subpart 31.2, which applies to contracts with commercial organizations. This column addresses the applicability of the FAR Cost Principles and their general criteria for determining the allowability of costs. Subsequent columns will address the allowability of selected items of cost.

APPLICABILITY OF THE FAR COST PRINCIPLES

The FAR Cost Principles apply to the “pricing of contracts, subcontracts, and modifications whenever cost analysis is performed.”¹ The FAR defines cost analysis as “the review and evaluation of any of the separate cost elements and profit or fee in an offeror’s or contractor’s proposal as needed to determine a fair and reasonable price or to determine cost realism. . . .”² The government must perform cost analysis analysis when cost or pricing data are required and may perform cost analysis to evaluate information other than cost or pricing data when it is not possible to determine a fair and reasonable price through price analysis alone.³ Cost analysis is frequently performed, and the Cost Principles frequently apply, in pricing both fixed-price and cost-reimbursement contracts.

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¹ FAR 31.000(a).

² FAR 15.404-1(c)(1).

³ FAR 15.404-1(a)(3),(4).

The Cost Principles also apply to modifications when a contract clause, such as the Changes clause,⁴ or the Suspension of Work clause,⁵ provides for an adjustment based on the contractor's cost.

The Cost Principles also apply to the determination, negotiation, and allowance of costs whenever required by a contract clause.⁶ The FAR requires the government to incorporate the FAR Cost Principles by reference in contracts with commercial organizations as the basis for:

- (1) Determining reimbursable costs;
- (2) Negotiating indirect cost rates;
- (3) Proposing, negotiating, or determining costs under terminated contracts;
- (4) Price revision of fixed-price incentive contracts;
- (5) Price redetermination of price redetermination contracts; and
- (6) Pricing changes and other contract modifications.⁷

Examples of contract clauses that incorporate the FAR Cost Principles include the Allowable Cost and Payment clause,⁸ and the standard Termination for Convenience clauses.⁹

DETERMINING ALLOWABILITY

A contractor may include costs in billings, claims, and proposals only if those costs are allowable.¹⁰ A cost is allowable only if it meets all of the following requirements:

- (1) Reasonableness;
- (2) Allocability;
- (3) Standards promulgated by the CAS [Cost Accounting Standards] Board, if applicable, generally accepted accounting principles and practices appropriate to the circumstances;
- (4) Terms of the contract; and

⁴ See, e.g., FAR 52.243-1, FAR 52.243-3, FAR 52.243-4.

⁵ See, e.g., FAR 52.242-14.

⁶ FAR 31.000(b).

⁷ FAR 31.103(b).

⁸ FAR 52.216-7.

⁹ See, e.g., FAR 52.249-1, FAR 52.249-2.

¹⁰ FAR 31.201-6(a).

(5) Any limitations set forth in [FAR subpart 31.2].¹¹

Each of these requirements is addressed below.

DETERMINING REASONABLENESS

As provided in the FAR, “[a] cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business.”¹² Importantly, there is no presumption of cost reasonableness.¹³ If an initial review of the facts results in the government challenging a specific cost, the contractor has the burden to prove that the cost is reasonable.¹⁴

The FAR provides that whether a cost is reasonable depends on a “variety of considerations and circumstances,” including the following:

- (1) Whether it is the type of cost generally recognized as ordinary and necessary for the conduct of the contractor’s business or the contract performance;
- (2) Generally accepted sound business practices and State laws and regulations;
- (3) The contractor’s responsibilities to the government, other customers, the owners of the business, employees, and the public at large; and
- (4) Any significant deviations from the contractor’s established practices.¹⁵

The “reasonableness” test focuses on two key questions: (1) whether the cost is of a type that a prudent business would incur, and (2) whether the amount is consistent with a fair market value. If a contractor can answer both questions affirmatively, then the costs are likely “reasonable” under FAR 31.201-3.

Costs that do not result from arms-length bargaining are more likely to be challenged as unreasonable. The FAR directs the government to examine the reasonableness of costs with “particular care” in connection with firms or separate divisions that may not be subject to effective competitive restraints.¹⁶ The Defense Contract Audit Agency (DCAA) frequently challenges the reasonableness of interdivisional work orders, subcontracts with affiliates, and

¹¹ FAR 31.201-2(a).

¹² FAR 31.201-3(a).

¹³ FAR 31.201-3(a).

¹⁴ FAR 31.201-3(a).

¹⁵ FAR 31.201-3(b).

¹⁶ FAR 31.201-3(a).

subcontracts with companies owned or managed by former employees. Documenting the negotiation process and rationale are critical for such transactions.

It is also common for deviations from a contractor's established practices to result in a finding that costs are unreasonable.¹⁷ Contemporaneously documenting the rationale for such deviations can significantly mitigate this risk.

Beyond the plain language of FAR 31.201-3, government auditors often consider the reasonableness of the conduct that gave rise to the cost (i.e., whether the contractor incurred the cost as a result of misconduct). When a contractor incurs a cost as a result of alleged "wrongdoing," government auditors generally assert that the cost is unreasonable, and therefore unallowable.

The government must evaluate reasonableness based on the particular contractor's operations, rather than a "universal, objective determination of what the cost would have been to other contractors at large."¹⁸ The government must not apply hindsight in evaluating cost reasonableness. Instead, "[r]easonableness is ascertained based upon the circumstances existing at the time the costs were incurred."¹⁹ Reasonableness requires prudence but not perfection.²⁰

DETERMINING ALLOCABILITY

The term "allocate" means "to assign an item of cost, or a group of items of cost, to one or more cost objectives," and includes "both direct assignment of cost and the reassignment of a share from an indirect cost pool."²¹ Unlike reasonableness, which turns on a qualitative judgment about the nature and amount of the cost, allocability is strictly an accounting concept for logically distributing costs to cost objectives (e.g., contracts) to determine the applicable cost to charge.²²

The FAR provides that a cost is allocable to a government contract if it:

¹⁷ Boeing Co., ASBCA No. 14370, 73-2 BCA ¶ 10,325 (Costs associated with building a replica of contractor's first airplane and conducting a tour of that replica were unreasonable because, *inter alia*, replica and tour deviated significantly from contractor's established practice).

¹⁸ Bruce Constr. Corp. v. United States, 324 F.2d 516 (Ct. Cl. 1963).

¹⁹ KBR Servs., Inc., ASBCA No. 57530, 19-1 BCA ¶ 37,205.

²⁰ Teledyne Indus., Geotech Div., ASBCA No. 18049, 73-2 BCA ¶ 10,088 (contractor could have cancelled subcontract earlier and reduced settlement costs but "perfection in contract administration is not one of the tests of the reasonableness of costs").

²¹ FAR 31.001.

²² Boeing North American, Inc. v. Roche, 298 F.3d 1274, 1280 (Fed. Cir. 2002) ("allocability is an accounting concept involving the relationship between incurred costs and the activities or cost objectives (e.g., contracts) to which the costs are charged").

- (a) Is incurred specifically for the contract;
- (b) Benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; or
- (c) Is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown.²³

Because the test for allocability is stated in the disjunctive, a cost is allocable to a government contract if it meets any of the foregoing criteria.²⁴

Costs directly related to a specific government contract, i.e., one and only one government contract, fall under FAR 31.201-4(a).²⁵ Such costs are allocable to the specific contract to which they relate as direct costs of that contract.²⁶

Costs relating to multiple contracts, and allocable pursuant to FAR 31.201-4(b) or FAR 31.201-4(c), are indirect costs.²⁷ A contractor must accumulate such costs in homogeneous indirect cost pools and allocate them to government and commercial contracts using an appropriate base.²⁸

Although FAR 31.201-4 is drafted in the disjunctive, courts and boards of contract appeals determining whether a contractor may allocate a cost to government contracts as an indirect cost generally treat subsections (b) and (c) as complementary. The Armed Services Board of Contract Appeals has explained the relationship between the two subsections as follows:

The more that a claimed cost satisfies the business necessity requirement in subsection (c), the more the contractor's burden to satisfy the benefit requirement in subsection (b) is reduced. . . . [A]ny expense which is so necessary that absent its incurrence a contractor could not continue in business would automatically be held to benefit or bear an equitable relationship to Government contracts. However, where the cost incurred is not necessary in the absolute sense, some benefit must be shown in order for a cost to be allocable to a Government contract.²⁹

²³ FAR 31.201-4 (emphasis added).

²⁴ General Dynamics Corp., Elec. Boat Div., ASBCA No. 18503, 75-2 BCA ¶ 11,521.

²⁵ FAR 2.101 ("Costs identified specifically with a contract are direct costs of that contract.").

²⁶ FAR 31.202(a) ("Direct costs of the contract shall be charged directly to the contract.").

²⁷ FAR 2.101 (" 'Indirect cost' means any cost not directly identified with a single final cost objective, but identified with two or more final cost objectives. . . .").

²⁸ FAR 31.203(c).

²⁹ Lockheed-Georgia Co., ASBCA No. 27660, 90-3 BCA ¶ 22,957 (quoting General

Courts and boards of contract appeals have adopted a broad view of what constitutes a benefit to the government, resulting in determinations that a wide range of costs are allocable. Examples of these costs include:

- (1) Property taxes assessed on a contractor's commercial inventory determined to be allocable to government contracts because the government benefited from the contractor meeting its responsibility as a corporate citizen;³⁰
- (2) Costs incurred in the unsuccessful pursuit of a commercial tanker submarine program determined to be allocable because a successful endeavor would have benefited the government by generating engineering and construction data, adding to general knowledge of submarines;³¹ and
- (3) Foreign sales commissions determined to be allocable because foreign business decreases general and administrative expense rates applicable to government contracts.³²

COST ACCOUNTING STANDARDS

Contractors must account for their costs in accordance with the CAS, if applicable, or Generally Accepted Accounting Principles (GAAP), if the CAS are not applicable.³³ The CAS govern the measurement, assignment, and allocation of costs to certain types of government contracts. An earlier edition of the Cost Corner provided a high-level overview of the CAS, which will be addressed at length in future columns.

TERMS OF CONTRACT

A cost may be unallowable if the terms of a contract specifically so provide. In this respect, the government may contractually establish that certain types of costs will not be recoverable, even if a business might normally incur those costs, and despite the fact that the regulations do not specifically disallow the costs.³⁴

Dynamics Corp., Elec. Boat Div., ASBCA No. 18503, 75-2 BCA ¶ 11,521).

³⁰ Lockheed Aircraft Corp v. United States, 375 F.2d 786 (Ct. Cl. 1967).

³¹ General Dynamics Corp., Elec. Boat Div., ASBCA No. 18503, 75-2 BCA ¶ 11,521.

³² Daedalus Enters., Inc., ASBCA No. 43602, 93-1 BCA ¶ 25,499.

³³ See CBS Corp. v. United States, 90 Fed. Cl. 466 (2009) (holding that a contractor was not entitled to reimbursement of costs attributable to pension liabilities transferred to the segment buyer because the contractor had not accounted for those costs in accordance with the requirements of either the CAS or GAAP).

³⁴ Bearing Point, Inc., ASBCA No. 55354, 09-2 BCA ¶ 34,289 (upholding cost disallow-

Examples of FAR clauses that limit the recovery of costs include the Limitation of Funds,³⁵ Limitation of Cost,³⁶ and Limitation of Government Liability clauses,³⁷ which prescribe the maximum amount the government will be obligated to pay the contractor. Examples of contract-specific limitations on cost include negotiated dollar value thresholds for compensable changes and caps on rates proposed to make a contractor's proposal more competitive.

LIMITATIONS IN FAR SUBPART 31.2

Finally, despite a determination that a cost may be reasonable in nature and amount, and allocable to a particular contract, the cost may nonetheless be unallowable if it is identified as such by statute or regulation. FAR 31.205 specifically addresses the allowability of forty-six (46) selected items of cost. Many of these costs are identified as unallowable and thus not recoverable under a government contract. For example, FAR 31.205-15 provides that "fines" and "penalties" are unallowable. Subsequent Cost Corner columns will address the allowability of some of the most important selected items of cost addressed in FAR 31.205.

The absence of a Cost Principle for a particular item of cost, however, does not imply that the cost is either allowable or unallowable.³⁸ When a specific Cost Principle does not apply to a particular item of cost, "[t]he determination of allowability shall be based on the principles and standards in [FAR subpart 31.205] and the treatment of *similar or related selected items*."³⁹

The Federal Circuit explained the "similar or related" test as follows:

We think it is unlikely that the "related" test under FAR 31.204(c) was designed to make a particular cost item unallowable simply because it would not have been incurred but for the occurrence of an event that resulted in a disallowed cost. . . . In order for a cost to be "related," there must be a more direct relationship to the disallowed cost.⁴⁰

ances for premium pay because the contract imposed salary caps).

³⁵ FAR 52.232-22.

³⁶ FAR 52.232-20.

³⁷ FAR 52.216-24.

³⁸ FAR 31.204(d).

³⁹ FAR 31.204(d) (emphasis added).

⁴⁰ *Boeing North American, Inc. v. Roche*, 298 F.3d 1274, 1287 (Fed. Cir. 2002); see also *Stanford Univ.*, ASBCA No. 28240, 85-3 BCA ¶ 18446 (holding that bond issuance costs were "similar or related" to unallowable interest costs); *Grumman Aerospace Corp.*, ASBCA No. 34665, 90-1 BCA ¶ 22417 (holding that dividends were "similar or related" to unallowable cash compensation or stock bonuses); *General Dynamics Corp.*, ASBCA No. 31359, 92-1 BCA

Further, “[w]hen an unallowable cost has been incurred, its directly associated costs are also unallowable.”⁴¹ A “directly associated cost” is one that is: (1) “generated solely as a result of incurring another cost” and (2) “would not have been incurred had the other cost not been incurred.”⁴² In other words, “directly associated costs” are costs that would not have been incurred “but for” the incurrence of another unallowable cost.

CONCLUSION

This column has addressed the applicability of the FAR Cost Principles and their general criteria for determining the allowability of costs. The next edition of the Cost Corner will address other generally applicable aspects of the FAR Cost Principles, including direct and indirect costs, accounting for unallowable costs, and credits.

¶ 24698 (holding that launching and rollout flights were “similar or related” to unallowable advertising and sales costs).

⁴¹ FAR 31.201-6.

⁴² FAR 31.001; FAR 31.201-6(a).