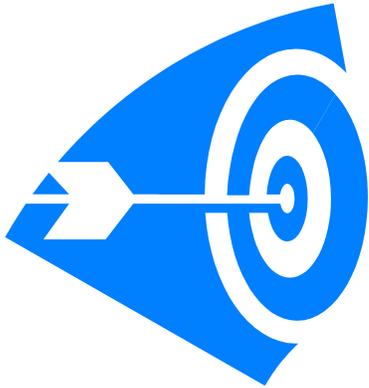


Allowability of Incurred Costs



Guiding Principle

Determining the allowability of incurred costs requires understanding the five FAR requirements for reimbursement. The subject is complex. Misunderstandings can be minimized by early communication.

References

FAR Part 31	Contract Cost Principles and Procedures
DEAR Subpart 970.31	Contract Cost Principles and Procedures
DEAR Part 931	Contract Cost Principles and Procedures

I. Overview

This guide chapter discusses determining the allowability of incurred costs, emphasizing the five FAR requirements, especially the reasonableness requirement.

The chapter requires Contracting Officers, when reviewing current advance agreements or establishing new advance agreements, to ensure they: (1) neither provide that a cost unallowable per FAR Part 31 or applicable DOE cost principles is allowable nor agree to any other treatment of costs inconsistent with FAR Part 31 or applicable DOE cost principles; and (2) emphasize that the five requirements for allowability listed in FAR Subsection 31.201-2, especially the reasonableness requirement, must be met for the cost to be reimbursable.

The chapter also encourages Contracting Officers to be proactive in minimizing potential disputes over cost reasonableness and to communicate their view of a potentially troublesome cost's reasonableness to their contractors in writing before the cost is incurred.

II. Types of Contracts Affected

This guide chapter focuses on the reimbursement of incurred costs under cost-reimbursement contracts and contracts with cost-reimbursement line items.

(While not the focus of this guide chapter, many elements of the guidance provided apply to the pricing—which is primarily about estimated costs—of contracts, subcontracts, and modifications where cost analysis is performed.)

III. Background

Cost Allowability (Five Requirements; the Reasonableness Requirement)

Federal Acquisition Regulation (FAR) Part 31 discusses Federal contract cost principles and procedures. These principles and procedures apply to the pricing of contracts, subcontracts, and modifications where cost analysis is performed and to the determination, negotiation, or allowance of costs when required by a contract clause. Typically, FAR Part 31 (more specifically FAR subpart 31.2) is incorporated into a DOE contract by the DOE Payments and Advances clause at DEAR 970.5232-2 (in management and operating contracts) or the DOE Allowable Cost and Payment clause at 952.216-7 (in non-management and operating cost-reimbursement contracts and contracts with cost-reimbursement line items). The DOE specific cost principles supplement the FAR cost principles in management and operating contracts and in non-management and operating cost-reimbursement contracts and contracts with cost-reimbursement line items. They are incorporated into a contract by the DOE Payments and Advances clause or the DOE Allowable Cost and Payment clause.

FAR Subpart 31.2 addresses contracts with commercial organizations and stipulates costs are allowable (that is, reimbursable by the Government) to the extent they are reasonable, allocable, and determined to be allowable under FAR Sections 31.201 (general costs), 31.202 (direct costs), 31.203 (indirect costs), and 31.205 (selected costs).

FAR Subsection 31.201-2 specifies a cost is allowable only if it complies with five requirements: reasonableness, allocability, cost accounting standards if applicable (otherwise generally accepted accounting principles and practices appropriate to the circumstances), the terms of the contract, and the limitations set forth in FAR Subpart 31.2. (This language is a somewhat inelegant since FAR Subsection 31.201-2 is one of the “terms of the contract” by virtue of either the Payments and Advances clause or the Allowable Cost and Payment clause included in the contract. Both clauses incorporate the FAR cost principles and the applicable DOE cost principles.)

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. If the contractor is not subject to effective competitive restraints, reasonableness of costs must be examined with particular care.

What is reasonable depends on, among other things, whether the cost: is generally recognized as ordinary and necessary for the conduct of a contractor's business or contract performance; incurred per a generally accepted sound business practice, arm's-length bargaining, law, and regulation; congruent with the contractor's responsibilities to the Government and the public at large; and consistent with the contractor's established practices. No presumption of reasonableness is attached to the incurrence of costs by a contractor. If the Government's initial review of the facts results in a challenge of a cost by the Government, the burden of proof is on the contractor to establish that the cost is reasonable.

A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship and, subject to the foregoing, is allocable if it: is incurred specifically for the contract; benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; or is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown.

The Cost Accounting Standards and policies and procedures for applying them are found at 48 CFR Chapter 99 (FAR) Appendix and FAR Part 30. They were formulated specifically for Federal procurement and address the measurement, assignment, and allocation of costs to negotiated Government contracts and subcontracts. Some contracts and subcontracts are exempt from the Cost Accounting Standards. Exemptions are listed at 48 CFR Chapter 9903.201-1(b) (FAR) Appendix. Even though a contract may be exempt from the Cost Accounting Standards, it remains subject to the measurement, assignment and allocability rules of selected Cost Accounting Standards because certain cost principles in FAR subpart 31.2 incorporate those rules. Contracts not subject to full Cost Accounting Standards coverage, for example, are subject to the applicable Cost Accounting Standards provisions in paragraphs (b) through (h) of FAR section 31.203. Generally accepted accounting principles and practices come from a variety of sources. They are a combination of authoritative standards and the commonly accepted ways of recording and reporting accounting information. Their focus is financial accounting. They reflect a general agreement as to which economic resources and obligations should be recorded as assets and liabilities, which changes in assets and liabilities should be recorded, when they should be recorded, how the assets and liabilities and changes in them should be measured, what information should be disclosed, how it should be disclosed, and which financial statements should be prepared. They were not formulated specifically for Federal procurement, and their shortcomings in addressing pricing and accounting issues that arise frequently in Government contracts were a primary reason for the dissemination of the Cost Accounting Standards.

The terms of the contract, in addition to those that explicitly address FAR or DEAR cost principles, can affect a cost's allowability in a number of ways. A contract term that requires

compliance with a statute would preclude reimbursement of costs a contractor incurred in deliberately flouting the statute. A contract provision that sets a ceiling on an indirect cost rate that the contractor can use to claim costs would preclude reimbursement of any additional costs calculated using a rate higher than the ceiling. A labor-hour contract (by definition) would preclude reimbursement of any material costs.

The limitations set forth in FAR Subpart 31.2 include both the “Selected costs” of FAR Section 31.205 (the “cost principles”) and the guidance of FAR Sections 31.201 through 31.204.

FAR Section 31.205, among other things, establishes that certain costs are specifically unallowable and certain costs are specifically allowable. In the latter instance, FAR 31.205 does not mean a selected cost cited as specifically allowable will always be allowable (that is, the Government will reimburse the cost). The selected cost still must meet all of FAR 31.201-2’s five requirements. Even though certain costs of depreciation, compensation, and relocation, for example, are specifically allowable in FAR 31.205, if the costs do not also meet each of the five requirements listed in FAR 31.201-2, they will not be reimbursed by the Government.

Advance Agreements

To avoid disallowance or dispute based on unreasonableness, unallocability, or unallowability under the cost principles, FAR encourages Contracting Officers and contractors to seek advance agreement on the treatment of special or unusual costs but cautions Contracting Officers that they are not authorized to agree to a treatment of costs inconsistent with FAR Part 31 or to provide that a cost unallowable per FAR Part 31 is allowable.

Occasionally, in their zeal to act as good stewards of the taxpayers’ dollars and manage their contracts efficiently, Contracting Officers establish advance agreements that bring about the exact opposite of what they were intended to achieve. That is, they increase the probability of disallowance of a cost or a dispute over it because the language of the agreements creates an ambiguity. Most often this ambiguity pertains to the reasonableness requirement.

Advance agreements may, among other things, state a certain cost will not be reimbursed, will be reimbursed up to a ceiling, or will be reimbursed. Regarding reasonableness of a cost, advance agreements may not state that the nature and amount of the cost they address will always be considered reasonable. They may establish only that the nature and amount of a particular cost will not always be considered specifically unreasonable. In other words, advance agreements regarding a particular cost must always, regardless of their subject, emphasize that FAR Part 31’s five requirements for reimbursement, especially reasonableness, remain applicable to the particular cost.

Advance agreements should not simply state, for example, that travel costs up to a ceiling are allowable. Such language could mislead some parties to believe, erroneously, any travel costs incurred below the ceiling would be reimbursed. Per FAR Part 31, only travel costs **both below the ceiling and otherwise allowable per FAR Part 31** (and in DOE, of course, this includes the applicable DOE cost principles) would be reimbursed. One way of ensuring appropriate emphasis is given to all of the five requirements is to preface any discussion of a cost's allowability with the following language: "If not otherwise unallowable per the terms of the contract, including the requirements of FAR Subsection 31.201-2 and of applicable DOE cost principles."

Cost Reasonableness:
Contracting Officer Actions Before Costs Are Incurred

Disputes over an incurred cost's reasonableness can be a source of unnecessary friction between the Government and a contractor. Once the contractor has incurred a cost in fulfilling its obligations under its contract it is understandable if the contractor is extremely reluctant to pay the cost out of its own pocket. Courts and Boards have been sympathetic to contractors' appeals of Government decisions to disallow costs because the costs were unreasonable.

On the other hand, if the contractor knows before it incurs a cost that the cost's reasonableness will be questioned, most disputes regarding a cost's reasonableness can be avoided. A contractor would likely avoid incurring any cost the Government had indicated it would consider unreasonable.

Advance agreements are not always employed. And it is neither practical nor desirable to address every cost under every circumstance under cost-reimbursement contractual arrangements. There are occasions, however, where the Government is aware the contractor may be contemplating incurring certain costs that would likely lead to disputes over their reasonableness. In such situations, both parties will benefit from a statement from the Contracting Officer indicating what the Government will consider reasonable.

IV. Guidance

Advance Agreements

In administering cost-reimbursement contracts and other contractual vehicles under which the Government must reimburse a contractor's incurred costs, Contracting Officers should seek to establish advance agreements where appropriate on the treatment of special or unusual costs. Contracting Officers shall not agree that a cost unallowable per FAR Part 31 or applicable DOE cost principles is allowable or that any other treatment of costs inconsistent with FAR Part 31 is permitted. Advance agreements regarding costs must always emphasize that, regardless of their language, the Government will only reimburse costs if each of the five requirements for

allowability listed in FAR Subsection 31.201-2 are met, especially the reasonableness requirement. Contracting officers must preface any discussion of a cost's allowability with the following or similar language: "If not otherwise unallowable per the terms of the contract, including the requirements of FAR Subsection 31.201-2 and of applicable DOE cost principles."

Cost Reasonableness: Contracting Officer Actions Before Costs Are Incurred

In administering cost-reimbursement contracts and other contractual vehicles under which the Government must reimburse a contractor's incurred costs, Contracting Officers should consider if it is prudent to specify what the Government will consider reasonable regarding a particular cost prior to the contractor's incurring the cost. The Contracting Officer may proscribe the cost, set a ceiling on the cost, establish criteria for determining the reasonableness of the cost, or take any other action he/she deems prudent to avoid unnecessary disputes regarding the reasonableness of a potential future cost before the contractor incurs it. Contracting Officers should attempt to accomplish such understandings working with contractors, but if circumstances do not permit mutual agreement to be reached in a timely manner they should not hesitate to take unilateral action. Written communication of any ilk from a Contracting Officer to a contractor will help minimize misunderstandings over what the Government will consider reasonable.

Examples

An advance agreement regarding meals may not state that the nature and amount of the cost of employees' meals will always be considered reasonable. Prudent business people do not routinely pay the costs of their employees' meals. An employee working late does not routinely receive a free meal — the nature of the expense is not reasonable. An occasion could arise, however, in which the Government imposed a last minute stringent deadline, and the contractor, at the last minute, told a critical employee to work late and paid for her meal. The nature of this expense is reasonable. Even if the nature of the expense is reasonable, part of the expense could be unallowable because it is excessive. So in the previous example, if the contractor provided a lobster and steak meal to the employee, the amount of the expense would be unreasonable and only the cost of a standard meal would be allowable. Finally, the contractor's cost of providing meals to employees at normal recurring meetings would not be allowable since the nature of the cost is not reasonable.

An advance agreement regarding travel expenses may not state that the nature and amount of all of the cost of employees' travel expenses on extended assignments will always be considered reasonable. Prudent business people do not routinely pay all of the cost of their employees' travel expenses if the employees are on extended assignment — the nature of all of the expenses is not reasonable. An occasion could arise, however, in which the Government imposed a

requirement that necessitated a contractor's employee's extended assignment and the particular circumstances justified some reimbursement of travel expenses. The nature of these expenses is then reasonable. Even if the nature of the expenses is reasonable, a portion of the expenses could be unallowable because the total of the expenses is excessive. So in the previous example, if the contractor provided its employee a travel allowance far in excess of Federal norms, the amount of the expense would be unreasonable and only the portion of the expense in line with Federal norms would be allowable. Finally, after some period of time, the employee's travel expenses would exceed any relocation costs and therefore typically not be allowable since the nature of the expenses would not be reasonable.

If a Contracting Officer believes travel will not be necessary under a cost-reimbursement contract that does not include an advance agreement on travel, the Contracting Officer should consider providing a written statement to the contractor indicating the Government will not consider travel costs reasonable.

If a Contracting Officer believes local travel will be necessary but easily accommodated using public transportation (as opposed to renting cars) under a cost-reimbursement contract that does not include an advance agreement on travel, the Contracting Officer should consider providing a written statement to the contractor indicating the Government will not consider travel costs for renting cars reasonable.