

Thoughts About the FAR Cost Principles

Written by Nick Sanders
Tuesday, 04 April 2017 00:00

When are the allowability rules of the FAR Part 31 Cost Principles applicable to your contract or your modification? For example, let's say you have just won a firm, fixed-price contract in a competition. As you incur costs and charge them to that contract, are those costs subject to the cost allowability rules? What about the indirect costs allocated to that contract via indirect cost rates—are they subject to the cost allowability rules?

Those questions are just the tip of the iceberg. There seems to be a decent amount of confusion surrounding when, and if, the Cost Principles apply. We'll try to tackle some of those questions in today's article.

Scope of FAR Part 31

Too many people just look at the principles covering selected areas of cost (at 31.205) without looking first at the scope and applicability rules. Let's start with the scope, found at 31.000—

This part contains cost principles and procedures for—

(a) The pricing of contracts, subcontracts, and modifications to contracts and subcontracts whenever cost analysis is performed (see 15.404-1(c)); and

(b) The determination, negotiation, or allowance of costs when required by a contract clause.

Right off the bat, we see that the applicability of the Cost Principles does *not* turn on contract type. They are just as applicable to FFP types as they are to cost-reimbursable types. The Cost Principles are applicable “whenever cost analysis is performed.” In addition, they are applicable whenever a contract clause requires them to be used.

But when is cost analysis required? Looking at FAR 15.404-1(a), we see that cost analysis is

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performed by a contracting officer in order to reach a determination that the proposed price is fair and reasonable. In order to reach that determination, the CO will perform “price analysis” when certified cost or pricing data has not been required. However, if cost or pricing data (whether certified or not) has been required, then the price analysis must be augmented by cost analysis. The FAR states—

Cost analysis shall be used to evaluate the reasonableness of individual cost elements when certified cost or pricing data are required. ... Cost analysis may also 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 for commercial or non-commercial items.

In a competitive acquisition, normally price analysis alone is sufficient to determine that the proposed price is fair and reasonable. In some cases, the CO may be prohibited from requiring certified cost or pricing data (see FAR 15.403-1). In addition, certified cost or pricing data “are not required” when a contract option is exercised at the price established at the initial contract award, or for proposals “used solely for overrun funding or interim billing price adjustments” (see FAR 15.403-2).

However, even if the CO is prohibited from requiring certified cost or pricing data, the CO is still permitted to require submission of (uncertified) cost or pricing data. In particular, the CO is encouraged to request “cost data” when “adequate price competition” has not been achieved (see FAR 15.403-3(a)(1)(iii)). Further, the CO may request “data other than certified cost or pricing data” when considered to be necessary to support the determination that the price is fair and reasonable—even if acquiring commercial items (see FAR 15.403-3(c)(1)).

The above may seem prescriptive, but the FAR gives the contracting officer wide latitude and discretion to determine when cost analysis is necessary, or when to require cost or pricing data to support that analysis. The FAR says (at 15.404-1(a)(1)) “The complexity and circumstances of each acquisition should determine the level of detail of the analysis required.”

Now we see that there is no “bright line” as to when the FAR Cost Principles apply. They apply whenever cost analysis is performed, and that is largely left up to the discretion of the contracting officer. The FAR cost principles may apply to a firm, fixed-price proposal. The Cost Principles may apply even to a proposal for commercial items!

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But that is with respect to cost proposals, not actual costs. What that all means is that proposed costs will be evaluated in accordance with the FAR Cost Principles, when a CO uses cost analysis to examine the proposed price. When actual costs are incurred, the Cost Principles are irrelevant to certain contract types (e.g., FFP) or to certain types of acquisitions (e.g., commercial items) because the price has already been agreed to, and contractor costs after that point largely have no impact on the agreed-to price. For that reason, FFP contracts (and related contract types) do not have the Allowable Cost and Payment clause (52.216-7) included in them.

Applicability of the Cost Principles

The Applicability Subpart of FAR Part 31 (found at 31.1) establishes (and reiterates) much of what we discussed above, plus adds additional requirements with respect to application of the Cost Principles to the determination of reimbursable costs and calculation of indirect cost rates. One important aspect of the Applicability Subpart is how the Cost Principles are to be applied to negotiating a price for firm, fixed-price contracts and modifications thereto. The FAR states (at 31.102)—

... application of cost principles to fixed-price contracts and subcontracts shall not be construed as a requirement to negotiate agreements on individual elements of cost in arriving at agreement on the total price. The final price accepted by the parties reflects agreement only on the total price. Further, notwithstanding the mandatory use of cost principles, the objective will continue to be to negotiate prices that are fair and reasonable, cost and other factors considered.

That's some important language, right there. We suggest you keep it handy for use in future negotiations.

With respect to the other applications of the Cost Principles, the prescription for use is fairly clear. The FAR states—

... the contracting officer shall incorporate the cost principles and procedures in Subpart 31.2

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and agency supplements by reference in contracts with commercial organizations as the basis for—

(1) Determining reimbursable costs under—

(i) Cost-reimbursement contracts and cost-reimbursement subcontracts under these contracts performed by commercial organizations and

(ii) The cost-reimbursement portion of time-and-materials contracts except when material is priced on a basis other than at cost (see 16.601(c)(3));

(2) Negotiating indirect cost rates (see Subpart 42.7);

(3) Proposing, negotiating, or determining costs under terminated contracts (see 49.103 and 49.113);

(4) Price revision of fixed-price incentive contracts (see 16.204 and 16.403);

(5) Price redetermination of price redetermination contracts (see 16.205 and 16.206); and

(6) Pricing changes and other contract modifications

To wrap this up, there are many points in the contract lifecycle when the Cost Principles may apply. Companies doing business with the Federal government—even if selling only commercial items—should be familiar with the rules of applicability and be prepared to comply when required to do so. There is some wiggle room (as noted), but that doesn't mean a contracting officer will give your company a pass when they are expecting submission of cost or pricing data and expecting to use the Cost Principles to evaluate that data.

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In a future article, we'll explore how a small business can be exempt from the Cost Accounting Standards, but still be required to comply with them.