

13. COST PRINCIPLES

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13.1 INTRODUCTION

The allowability of costs is a prominent subject in the formulation and administration of contracts. Analysts must be very knowledgeable of cost principles to accurately perform cost analyses and adequately support the contracting officer (CO) during contract administration. This chapter introduces cost principles, specifically the FAA Contract Cost Principles (FAA AMS Procurement Guidance T3.3.2) and highlights key concepts. In addition, this chapter will discuss the following as they relate to commercial organizations:

- Cost Principles versus Cost Accounting Standards (CAS)
- Applicability
- Elements of Allowability
- Enforcement
- Advance Agreements
- Highlights of FAA Contract Cost Principles

13.2 COST PRINCIPLES VERSUS COST ACCOUNTING STANDARDS

CAS and cost principles are related, but are not interchangeable. CAS addresses accounting--the measurement, assignment, and **allocation of costs** to Government contracts. Cost principles address **cost allowability**. Cost allowability is a procurement matter and is a function of law, regulation, or contract clauses. Costs may be allocable but not allowable.

Some of the cost principles have directly incorporated certain CAS. If costs related to cost principles are not accounted for in accordance with CAS, then the cost is unallowable. Table 13-1 provides examples of the link between certain cost principles and CAS.

Allocable Cost: A cost that is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or some other equitable relationship.

Allowable Cost: A cost that 1.) meets the test of reasonableness and allocability, 2.) is in accordance with standards promulgated by the Cost Accounting Standards Board (if applicable) or otherwise conforms to generally accepted accounting principles, 3.) follows specific limitations or exclusions set forth in the FAA contract cost principles, and 4.) abides by the terms of the contract.

Table 13-1. Cost Principles Versus CAS

Cost Principle	CAS		
Consistency (general principle)	401	402	
Accounting for unallowable costs (general principle)	405		
Cost accounting period (general principle)	406		
Compensation for personal services	412	413	415
Cost of money	414	417	
Depreciation	409		
Independent research & development and bid & proposal costs	420		
Insurance & Indemnification	416		

13.3 APPLICABILITY TO FAA CONTRACTING

The FAA's AMS has established Contract Cost Principles which are used for: 1.) the pricing of contracts, subcontracts, and modifications to contracts and subcontracts when cost analysis is performed, and 2.) the determination, negotiation, or allowance of costs when required by a contract clause (e.g., economic price adjustment or fixed-price incentive contracts). In accordance with FAA AMS, section 3.3.2.1, the CO will incorporate the cost principles and procedures in contracts with commercial organizations as the basis for the following:

1. The determination of allowable, allocable, and reasonable costs under cost reimbursement contracts and cost reimbursement subcontracts and the cost reimbursement portion of time and materials contracts except when material is priced on a basis other than cost;
2. The negotiation of indirect cost rates, when any of the following conditions exist:
 - a) FAA has division or corporate contract administration responsibilities;
 - b) Quick close-out procedures are used; or
 - c) Indirect rate caps are negotiated in the contract;
3. The determination or negotiation of 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.

When division or corporate contract administration responsibilities rest with another Government agency (i.e. when the largest percentage of the company or segment's business base is with another agency), the FAA will yield to the cost principles of the administering agency for the settlement of indirect costs under a FAA contract.

WARNING:

Do not assume that the use of cost principles when analyzing and negotiating fixed-price contracts indicates that every element of cost has been agreed upon. How a Contractor calculates a bottom line price may be different from the way in which the Government does. The final negotiated price reflects only agreement on the total price.

13.4 ELEMENTS OF ALLOWABILITY

Cost principles contain explicit rules concerning whether certain costs are allowable and under what conditions they are considered reasonable and/or allocable. However, cost principles are only one of five factors which should be considered when determining allowability [FAA AMS Procurement Guidance T3.3.2A.2.b(1) (Contract Cost Principles)]. Each of the five criteria is discussed below.

- 1. Reasonableness.** The nature and amount of the cost must not exceed that which would be incurred by a prudent person in a competitive business. The cost must be ordinary and necessary for running a business or performing a particular contract. The analyst must scrutinize costs particularly in situations where the cost is not significantly influenced by competitive market forces.
- 2. Allocability.** The cost must be assignable to the contract either directly or indirectly. A cost should be charged directly if it is specifically incurred for a particular contract. If the cost benefits the contract as well as other cost objectives or the cost is necessary for the overall operation of the business, the cost should be charged indirectly through overhead or G&A, respectively.
- 3. CAS Standards.** The contractor should follow CAS if applicable; otherwise, the contractor should follow generally accepted accounting practices and principles.
- 4. Terms of the contract.** The contractor and the FAA CO can negotiate terms that would make certain costs unallowable, for example, charging local travel directly to the contract. However, the CO cannot make an unallowable cost allowable under any circumstances, for example, holiday parties cannot be made allowable by the CO.

5. Any limitations set forth in AMS T3.3.2A.2(b) “Contracts with Commercial Organizations”.

13.5 ENFORCEMENT

A major responsibility in contract administration is the enforcement of the cost principles in contracts that are not fixed-price or fixed-price with Economic Price Adjustment (EPA) provisions. The administering CO can disallow costs that are unallowable and can assess a monetary penalty for unallowable costs which are included in indirect cost pools.

13.5.1 Disallowance of Cost During Contract Performance

The CO may disallow costs that are unallowable prior to or after incurrence of the subject costs. The CO may issue a “Notice of Intent to Disallow Costs” in accordance with FAA Clause 3.10.1-1. The contractor has 60 days to respond and justify the allowability of such costs. Upon receipt of the response, the CO shall review the contractor’s justification and either withdraw the notice or issue a final decision. The final decision is subject to the FAA’s Dispute Resolution System.

The CO can still take exception to costs incurred without issuing a notice. The CO can disapprove and withhold vouchered costs considered unallowable. If the contractor disagrees, it can send a written request to the CO to reconsider the withholding and/or it can file a claim subject to the FAA’s Dispute Resolution System.

13.6 ADVANCE AGREEMENTS

Disputes concerning cost principles can be avoided through the use of Advance Agreements. Advance Agreements record the common understanding of the contractor and the CO on the reasonableness, allocability, and allowability of various costs. Since there are many complex contracting situations and many accounting systems, Advance Agreements are encouraged particularly for special circumstances, unusual costs or on statistical sampling procedures. (FAA AMS Procurement Guidance T3.3.2A.1.i (Contract Cost Principles)) However, there is no requirement to negotiate Advance Agreements, and the lack of an advanced agreement will not affect the reasonableness, allocability, or allowability of costs.

Advance Agreements can be negotiated before or during contract performance and can apply to a single contract, a group of contracts, all contracts of the agency, or all contracts of many agencies. Advance Agreements should be negotiated before the costs involved have been incurred. The agreement must be in writing, be signed by both parties, and be incorporated into current and

future contracts, as applicable. The agreement should also adequately describe the situation, address the treatment of the costs, and contain a statement of applicability and duration.

The following are some examples of costs where Advance Agreements may be important:

CAUTION:

The CO cannot make an otherwise unallowable cost allowable. For example, bad debt cannot be made allowable. Furthermore, Advance Agreements are not contracts; they merely document mutual agreement on the treatment of costs.

- Compensation for personal services (including but not limited to: off-site pay, incentive pay, location allowances, hardship pay, cost of living differential, and termination of defined benefit pension plans);
- Use charges for fully depreciated assets;
- Deferred maintenance costs;
- Independent research and development and bid & proposal costs;
- Royalties and other costs for use of patents;
- Selling and distribution costs;
- Travel and relocation costs, as related to: 1.) special or mass personnel movements, 2.) travel via contractor-owned, leased, or chartered aircraft, or 3.) maximum per diem rates;
- Costs of idle facilities and idle capacity;
- Costs of automatic data processing equipment;
- Severance pay to employees on support service contracts;
- Plant reconversion;
- Professional services (e.g., legal and engineering);
- General and administrative costs (e.g., corporate, division, or branch allocations) attributable to the general management, supervision, and conduct of the contractor's business as a whole. These costs are particularly significant in construction, job-site, architect-engineer, facilities, and Government-owned contractor operated (GOCO) plant contracts;
- Costs of construction plant and equipment;
- Costs of public relations and advertising;
- Training and education costs; and
- Pre-contract costs (treatment of costs only; should not use to authorize costs).

13.7 THE COST PRINCIPLES

13.7.1 The FAA Contract Cost Principles

The actual cost principles are available in the AMS Procurement Guidance T3.3.2.D, Appendix 2 (http://fasteditapp.faa.gov/ams/do_action?do_action=ListTOC&contentUID=3). The Cost Principles are not all-inclusive; the exclusion of an item of cost does not imply that it is either allowable or unallowable. When more than one principle applies to an element of cost, the determination of allowability will be based on the guidance contained in the principle that best captures the essential nature of the cost at issue.

13.7.2 Cost Principles for other Situations

There is special guidance in the principles regarding construction and architect-engineering and facilities contracts. Refer to the FAA AMS Procurement Guidance T3.3.2A.1.e for further information.