

Contract Administration

Activity 42: Allowability of Costs

Procedures for determining the allowability of costs.

Related Flow Charts: [Flow Chart 42](#)

Part A: Disallowance of Costs

Tasks	FAR Reference(s)	Additional Information
<p>1. Determine allowability of incurred costs or costs planned for incurrence.</p>	<p>FAR 31.201-2 Determining allowability [contracts with commercial organizations].</p> <p>FAR 31.201-3 Determining reasonableness [contracts with commercial organizations].</p> <p>FAR 31.201-4 Determining allocability [contracts with commercial organizations].</p> <p>FAR 31.201-6 Accounting for unallowable costs [contracts with commercial organizations].</p> <p>FAR 31.201-7 Construction and architect-engineer contracts [contracts with commercial organizations].</p> <p>FAR 31.205 Selected costs.</p> <p>FAR 42.803 Disallowing costs after incurrence.</p>	<p>When monitoring contract costs, reviewing cost vouchers, or reviewing requests for progress payments, recognize incurred costs or costs planned for incurrence under a contract that are apparently unallowable.</p> <p>A cost is allowable only when it complies with all of the following requirements:</p> <ul style="list-style-type: none"> • Cost reasonableness; • Cost allocability to the contract; • Standards promulgated by the Cost Accounting Standards Board, if applicable, otherwise, generally accepted accounting principles and practices appropriate to the particular circumstances; • Terms of the contract; and • Any limitations set forth in FAR Part 31. <p>Obtain input from the cognizant auditor when there is question as to whether the cost is allowable.</p> <p>Prepare a position and supporting data on allowability for discussions with the contractor.</p>

Tasks	FAR Reference(s)	Additional Information
2. Attempt to reach a satisfactory settlement through discussions with the contractor.	FAR 42.801(a) Notice of intent to disallow costs.	<p>Obtain any additional information from the contractor that may bear on the decision of cost allowability.</p> <p>Do not accept any agreement that would result in the Government paying an unallowable cost.</p>
3. Prepare a notice of intent to disallow costs.	FAR 42.801(c) Notice of intent to disallow costs.	<p>As a minimum, the notice must:</p> <ul style="list-style-type: none"> • Refer to the contract’s Notice of Intent to Disallow Costs clause; • State the contractor’s name and list the numbers of the affected contracts; • Describe the costs to be disallowed, including estimated dollar value by item and applicable time periods, and state the reasons for the intended disallowance; • Describe the potential impact on billing rates and forward pricing rate agreements; • State the notice’s effective date and the date by which written response must be received; • List the recipients of copies of the notice; and • Request the contractor to acknowledge receipt of the notice.
4. Issue the notice of intent to disallow costs to the contractor and obtain acknowledgement of contractor receipt.	<p>FAR 42.801(d) Notice of intent to disallow costs.</p> <p>FAR 42.801(e) Notice of intent to disallow costs.</p>	<p>The contracting officer issuing the notice must furnish copies to all contracting officers cognizant of any segment of the contractor’s organization.</p> <p>If the notice involves elements of indirect cost, it must not be issued without coordination with the contracting officer or auditor having authority for final indirect cost settlement (see FAR 42.705).</p>

Tasks	FAR Reference(s)	Additional Information
<p>5. Respond to the contractor’s rebuttal (if any) of the decision.</p>	<p>FAR 42.801(f) Notice of intent to disallow costs.</p> <p>FAR 42.803 Disallowing costs after incurrence.</p>	<p>If the contractor disagrees in writing within 60 days to a notice of intent to disallow costs:</p> <ul style="list-style-type: none"> • Issue a written decision to withdraw the notice, sustain the original decision, or allow part of the costs unless elements of indirect costs are involved; or • Request the contracting officer responsible for determining final indirect cost rates to issue a decision when indirect costs are involved. <p>If the contractor disagrees with the deduction from current payments, respond based on the form of rebuttal. The contractor may:</p> <ul style="list-style-type: none"> • Submit a written request to the cognizant contracting officer to consider whether the unreimbursed costs should be paid and to discuss the findings with the contractor; • File a claim under the Disputes clause, which the cognizant contracting officer will process in accordance with agency procedures; or • Do both of the above. <p>Make a decision on the appropriate response after consulting the auditor. Keep the finance office abreast of any changes in the status of the disallowed or suspended costs.</p>
<p>6. Determine the penalty and interest (if any) for contractors that include unallowable costs in final indirect cost rate proposals or the final statements costs under a fixed-price incentive contract.</p>	<p>FAR 42.703-2(e) Penalties for unallowable costs [certificate of indirect costs].</p> <p>FAR 42.709 Scope [indirect cost rates].</p>	<p>This requirement applies to all contracts in excess of \$650,000, except fixed-price contracts without cost incentives or any firm fixed-price contracts for the purchase of commercial items.</p> <p>Follow the guidelines in FAR 42.709 for determining the applicability and assessment of penalties and interest.</p>

Part B: Payment of Indirect Costs

Tasks	FAR Reference(s)	Additional Information
1. Identify the official responsible for determining the final indirect cost rates for the business unit.	FAR 42.703-1 Policy [indirect cost rates].	Follow the guidance in FAR 42.705-1 and 42.705-2 to determine whether the contracting officer or auditor is responsible for final indirect cost rates.
2. Determine billing rates.	<p>FAR 42.701 Definition [indirect cost rates].</p> <p>FAR 42.703-1(b) Policy [indirect cost rates].</p>	<p>“Billing rate,” as used in FAR Subpart 42.7, means an indirect cost rate:</p> <ul style="list-style-type: none"> • Established temporarily for interim reimbursement of incurred indirect costs; and • Adjusted as necessary pending establishment of final indirect cost rates. <p>When determining billing rates:</p> <ul style="list-style-type: none"> • Base them on information from: <ul style="list-style-type: none"> ○ Recent review; ○ Previous rate audits or experience; or ○ Similar reliable data or experience of other contracting activities. • Ensure that they are as close as possible to the final indirect cost rates anticipated for the contractor’s fiscal period, adjusted for any unallowable costs. • If the dollar value of contracts requiring use of billing rates does not warrant submission of a detailed billing rate proposal, rates may be established by making appropriate adjustments from the prior year’s cost experience to: <ul style="list-style-type: none"> ○ Eliminate unallowable and nonrecurring costs; and ○ Reflect new or changed conditions. <p>Once established, billing rates may be prospectively or retroactively revised by mutual agreement of the parties involved at either party’s request, to prevent substantial overpayment or underpayment.</p> <p>When agreement cannot be reached, the contracting officer may</p>

Tasks	FAR Reference(s)	Additional Information
		<p>unilaterally determine rates.</p> <p>Never construe the elements of indirect costs and the base or bases used in computing billing rates as determinative of those to be used in final rate calculations.</p> <p>When the contractor provides the certified final indirect cost rate proposal, the contractor and the Government may mutually agree to revise billing rates to reflect the proposed indirect cost rates adjusted to reflect historically disallowed amounts, until the proposal has been audited and settled.</p>
<p>3. Determine whether or not to apply the quick-closeout procedure to settle indirect costs.</p>	<p>FAR 42.703-1(c)(1) Policy [indirect cost rates].</p> <p>FAR 42.708 Quick-closeout procedure [indirect cost rates].</p>	<p>Use the quick-closeout procedure at FAR 42.708 to settle indirect costs for a specific contract in advance of a determination of final indirect cost rates, when the following conditions are met:</p> <ul style="list-style-type: none"> • The contract, task order, or delivery order is physically complete; • The amount of unsettled direct costs and indirect costs to be allocated to the contract, task order, or delivery order is relatively insignificant. Cost amounts will be considered relatively insignificant when the total unsettled direct costs and indirect costs to be allocated to any one contract, task order, or delivery order does not exceed the lesser of: <ul style="list-style-type: none"> ○ \$1,000,000; or ○ Ten percent of the total contract, task order, or delivery order amount; • The contracting officer performs a risk assessment and determines that the use of the quick-closeout procedure is appropriate; and • Agreement can be reached on a reasonable estimate of allocable dollars.

Tasks	FAR Reference(s)	Additional Information
<p>4. Use the quick-closeout procedure to settle indirect costs.</p>	<p>FAR 42.708 Quick-closeout procedure [indirect cost rates].</p>	<p>Steps for use of quick-closeout procedures:</p> <ul style="list-style-type: none"> • Obtain the contractor’s proposed indirect cost rates and supporting data; • Prepare the Government’s position on the proposed rates; • Negotiate quick-closeout rates and other allowable costs for the contract; and • Modify the contract for closeout. <p>Determination of final indirect rates using the quick-closeout procedure is final for the contract it covers and there must not be any adjustment to other contracts for over- or under-recovery of costs allocated or allocable to the contract covered by the procedure.</p>

Tasks	FAR Reference(s)	Additional Information
<p>5. Obtain from the cognizant agency the final indirect cost rates for the period or periods during which the contract was effect.</p>	<p>FAR 42.705 Final indirect cost rates.</p>	<p>The contracting officer or auditor responsible for final indirect cost rate determination must execute a written understanding setting forth the final cost rates. The understanding must specify:</p> <ul style="list-style-type: none"> • The agreed-upon final annual indirect cost rates; • The bases to which the rates apply; • The periods for which the rates apply; • Any specific indirect cost items treated as direct costs in the settlement; and • The affected contract and/or subcontract, identifying any with advance agreements or special terms and the applicable rates. <p>The responsible official must:</p> <ul style="list-style-type: none"> • Promptly distribute executed copies of the indirect cost rate agreement to the contractor and to each affected contracting agency; • Provide copies of the agreement for the contract files; and • Furnish copies of the negotiation memorandum prepared under contracting officer determination or audit report prepared under auditor determination, as appropriate, to the contracting offices and Government audit offices.
<p>6. Apply the final indirect cost rates in establishing the final contract price.</p>	<p>FAR 42.705 Final indirect cost rates.</p>	<p>Within 120 days after settlement of the final indirect cost rates (or longer, if approved in writing by the contracting officer), the contractor must submit a completion invoice or voucher reflecting the settled amounts and rates on all contracts physically completed in the year covered by the proposal.</p> <p>That submission will be used as a basis for establishing final costs.</p>

Part C: Limitation of Costs, Funds, or Total Payment Amount

Tasks	FAR Reference(s)	Additional Information
<p>1. Determine if the contractor is approaching a limitation of funds, costs, or payments.</p>	<p>FAR 32.704 Limitation of cost or funds. FAR 52.232-7 Payments under time-and-materials and labor-hour contracts. FAR 52.232-20 Limitation of cost. FAR 52.232-22 Limitation of funds.</p>	<p>Cost-reimbursement, time-and-materials, and labor-hour contracts each include a limit on the Government’s financial obligation under the contract:</p> <ul style="list-style-type: none"> • A fully funded cost-reimbursement contract (for other than facilities) must include the Limitation of Cost clause (FAR 52.232-20). That clause limits the Governments obligation to reimburse the contractor for incurred costs to the established contract cost. • An incrementally funded cost-reimbursement contract must include the Limitation of Funds clause (FAR 52.232-20). That clause limits the Governments obligation to reimburse the contractor for incurred costs to the current level of funding on the contract. • A time-and-materials or labor-hour contract must include the Payments Under Time-and- Materials or Labor-Hour Contracts clause (FAR 52.232-7) which limits the Government’s obligation to the ceiling price or limitation on payments set in the contract. <p>When the limitation is reached the contractor entitled to stop work.</p> <p>As a result, each of these contract types should be monitored considering contract performance and related cost. In addition, each of the clauses identified above requires the contractor to notify the contracting officer if it expects to reach a stated percentage of the financial limit within the next 30 days.</p>

Tasks	FAR Reference(s)	Additional Information
<p>2. Decide on an appropriate course of action given the funding and programming information.</p>	<p>FAR 32.704 Limitation of cost or funds. FAR 52.232-7 Payments under time-and-materials and labor-hour contracts. FAR 52.232-20 Limitation of cost. FAR 52.232-22 Limitation of funds.</p>	<p>Potential courses of action include:</p> <ul style="list-style-type: none"> • Allotting additional funds or increasing the estimated cost in a specified amount; • Deciding not to further fund the contract and requesting the contractor to submit a proposal for an adjustment of fee, if any, based on the percentage of work completed in relation to the total work called for under the contract; and • Terminating the contract. <p>Under a cost-reimbursement contract, issuing a change order, a direction to replace or repair defective items or work, or a termination notice without immediately increasing the funds available.</p> <p>Government personnel encouraging a contractor to continue work in the funds will incur a violation of Revised Statutes section 3679 (31 U.S.C. 1341) that may subject the violator to civil or criminal penalties.</p>
<p>3. Notify the contractor in writing of the course of action.</p>	<p>FAR 32.704 Limitation of cost or funds. FAR 52.232-7 Payments under time-and-materials and labor-hour contracts. FAR 52.232-20 Limitation of cost. FAR 52.232-22 Limitation of funds.</p>	<p>Notify the contractor in writing if:</p> <ul style="list-style-type: none"> • Additional funds have been allotted, or the estimated cost has been increased, in a specified amount; • The contract is not further funded and that the contractor should submit a proposal for an adjustment of fee, if any, based on the percentage of work completed in relation to the total work called for under the contract; • The contract is to be terminated; or • The Government is considering whether to allot additional funds or increase the estimated cost. <p>For a time-and-material or labor-hour contract, notify the contract in writing if the ceiling price has been increased and specifies in the notice a revised ceiling that will constitute the ceiling price for performance under the contract.</p>

Tasks	FAR Reference(s)	Additional Information
4. Document the contract file.	FAR 4.803 Contents of contract files.	Document the contract file with information, such as: <ul style="list-style-type: none"> • The contractor’s notice; • A record of discussions with the contractor, including a price negotiation memorandum (when appropriate); and • A record of the action taken.