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**Department of
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Administration**

48 CFR Part 31

**Federal Acquisition Regulation;
Accounting for Unallowable Costs;
Proposed Rule**

DEPARTMENT OF DEFENSE**GENERAL SERVICES
ADMINISTRATION****NATIONAL AERONAUTICS AND
SPACE ADMINISTRATION****48 CFR Part 31**

[FAR Case 2004–006]

RIN 9000–AK06

**Federal Acquisition Regulation;
Accounting for Unallowable Costs**

AGENCIES: Department of Defense (DoD), General Services Administration (GSA), and National Aeronautics and Space Administration (NASA).

ACTION: Proposed rule.

SUMMARY: The Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council (Councils) are proposing to amend the Federal Acquisition Regulation (FAR) by revising language regarding accounting for unallowable costs.

DATES: Interested parties should submit comments in writing on or before November 29, 2004 to be considered in the formulation of a final rule.

ADDRESSES: Submit comments identified by FAR case 2004–006 by any of the following methods:

- Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.
- Agency Web Site: <http://www.acqnet.gov/far/ProposedRules/proposed.htm>. Click on the FAR case number to submit comments.
- E-mail: farcase.2004-006@gsa.gov. Include FAR case 2004–006 in the subject line of the message.
- Fax: 202–501–4067.
- Mail: General Services Administration, Regulatory Secretariat (V), 1800 F Street, NW, Room 4035, ATTN: Laurie Duarte, Washington, DC 20405.

Instructions: Please submit comments only and cite FAR case 2004–006 in all correspondence related to this case. All comments received will be posted without change to <http://www.acqnet.gov/far/ProposedRules/proposed.htm>, including any personal information provided.

FOR FURTHER INFORMATION CONTACT: The FAR Secretariat at (202) 501–4755 for information pertaining to status or publication schedules. For clarification of content, contact Mr. Richard C. Loeb, at (202) 208–3810. Please cite FAR case 2004–006.

SUPPLEMENTARY INFORMATION:**A. Background**

The DoD Director of Defense Procurement and Acquisition Policy (DPAP) established a special interagency Ad Hoc Committee to perform a comprehensive review of policies and procedures in FAR Part 31, Contract Cost Principles and Procedures, relating to cost measurement, assignment, and allocation. DPAP announced a series of public meetings in the **Federal Register** notice (66 FR 13712) on March 7, 2001 (with a “correction to notice” published in the **Federal Register** (66 FR 16186) on March 23, 2001). Public meetings were held on April 19, 2001, May 10–11, 2001, and June 12, 2001. Attendees at the public meetings included representatives from industry, Government, and other interested parties who provided views on potential areas for revision in FAR Part 31. The Ad Hoc Committee reviewed the cost principles and procedures and the input obtained during the public meetings; identified potential changes to the FAR; and submitted several reports, including draft proposed rules for consideration by the Councils.

The Councils reviewed the Ad Hoc Committee’s reports and draft proposed rules related to FAR 31.204, Application of principles and procedures, and FAR 31.201–6, Accounting for unallowable costs. On May 22, 2003, a proposed rule was published for public comment in the **Federal Register** (68 FR 28108) under FAR case 2002–006. No public comments were received on the proposed rule relating to FAR 31.204. The Councils concluded that the FAR 31.204 proposed rule should be converted to a final rule, with no changes to the proposed rule. The final rule version of 2002–006 was published in the **Federal Register** in Federal Acquisition Circular 2001–24 (69 FR 34224 on June 18, 2004).

As a result of the public comments received under FAR case 2002–006, the Councils also decided to make substantive changes to FAR 31.201–6 and to publish the proposed revisions under this separate proposed rule 2004–006. The Councils’ recommended changes include adding paragraphs (iii) through (vi) to subsection 31.201–6(c)(2) to provide specific criteria on the use of sampling as a method to identify unallowable costs, including the applicability of penalties for failure to exclude certain projected unallowable costs.

This is not a significant regulatory action and, therefore, was not subject to review under Section 6(b) of Executive Order 12866, Regulatory Planning and

Review, dated September 30, 1993. This rule is not a major rule under 5 U.S.C. 804.

In response to the proposed FAR rule published under FAR Case 2002–006 in the **Federal Register** (68 FR 28108) on May 22, 2003, nine respondents submitted comments on FAR 31.201–6. The Councils considered all comments and concluded that, since the changes result in a rule that differs significantly from the proposed rule, it should be published as a proposed rule under a new FAR Case 2004–006. Differences between the proposed rule under FAR Case 2002–006 and this proposed rule are discussed in Comments 3, 4, and 7, below.

Public Comments

FAR 31.201–6(c)(1)

1. *Comment:* Requirement to segregate unallowable costs. One respondent recommends removal of FAR 31.201–6(c)(1) from the proposed rule (which is also contained in the current FAR language). The respondent believes that non-CAS covered contractors should not be subject to CAS requirements because of their adherence to the FAR cost principles. The respondent also contends that incorporating such requirements into the FAR by reference results in lowering thresholds for CAS application and is contrary to DoD progressive initiatives such as the DoD Panel on Measurement, Assignment, and Allocability Provisions of FAR Part 31, and by the DFARS Transformation Project.

Another respondent believes that retaining the requirement, for all contracts subject to FAR Part 31 (CAS and non-CAS covered), to comply with the provisions of CAS 405 (Accounting for Unallowable Costs) results in more clearly understood and easily applied criteria for accounting for unallowable costs. This respondent also believes that such requirements create a more level playing field between all contractors.

Councils’ response: The Councils agree that the provision should be retained. Prior to the implementation of CAS 405, significant amounts of unallowable costs were often included in proposals and billings which necessitated significant use of Government resources to find such costs. The Councils believe this would occur again if the requirement was removed. In addition, unallowable costs must be segregated to comply with the statutory penalties provisions; thus, this provision serves to implement those statutory requirements.

FAR 31.201–6(c)(2)

2. *Comment:* Use of statistical sampling. The respondent believes that numerous disagreements may result from the proposed language. The respondent supports the use of statistical sampling to project unallowable costs in connection with discrete pools where the number of differing cost elements is limited. However, the respondent concurrently objects to the general application of statistical sampling for the purposes of projecting unallowable costs in connection with a universe of diverse cost elements subject to a significant number of cost principles.

Councils' response: Nonconcur. The Councils recognize the respondent's concern about the potential limitations of statistical sampling. However, the Councils note that contractors are not required to use statistical sampling, i.e., it is an optional technique for segregating unallowable costs.

FAR 31.201-6(c)(2)(iii), (iv), and (v)

3. *Comment:* Statistical sampling verification versus segregation. The respondent disagrees with the proposed amendment to FAR 31.201-6(c)(2). The respondent believes that the use of statistical sampling should not replace accounting policies and procedures for identifying and segregating unallowable costs when the costs are initially incurred and recorded. The respondent asserts that initial identification of unallowable costs is necessary to meet the requirements of 10 U.S.C. 2324, which provides penalties against a contractor if expressly unallowable costs are included in its claims to the Government. Therefore, the respondent recommends adding the following language:

"Statistical sampling is an acceptable practice for verifying that a contractor's accounting practices and procedures for segregating and presenting unallowable costs are operating as intended."

Councils' response: Concur in part. The Councils do not believe that sampling is precluded by 10 U.S.C. 2324. The Councils note that there is no requirement in 10 U.S.C. 2324 to specifically segregate every item of unallowable cost. Statistical sampling, when properly applied, is acceptable for both segregating unallowable costs and verifying that such costs have been properly segregated (either by specific identification or using appropriate sampling techniques). However, the Councils recognize that the sampling must appropriately consider the requirements of 10 U.S.C. 2324 related to the application of penalties on unallowable costs. To avoid potential disputes in this area, a new paragraph (c)(3) has been added at 31.201-6 to

explicitly include these appropriate considerations.

FAR 31.201-6(c)(2)(vi)

4. *Comment:* Statistical sampling advance agreements. A respondent states that up-front coordination and agreement between the contractor and the auditor regarding the sampling plan (e.g., sampling method, expense accounts, stratification, precision, confidence, and projection) is essential in order to avoid subsequent disputes over the adequacy of the sampling plan used by the contractor. The respondent asserts that such disputes, as well as differing interpretations of statistical terms and methodologies, could delay a timely settlement of the contractor's incurred cost submissions and adversely impact the contract close-out process. The respondent proposes adding the following language to FAR 31.201-6(c):

(3) Use of statistical sampling methods for identifying and segregating unallowable costs should be the subject of an advance agreement under the provisions of FAR 31.109.

Councils' response: Concur. The Councils believe it will streamline the review process and avoid potential disputes if the parties agree up-front on the sampling plan. The Councils have added the respondent's proposed language as well as an additional sentence on advance agreements at new paragraph (c)(4) of 31.201-6.

FAR 31.201-6(e)(1)

5. *Comment:* Materiality threshold applied to directly associated unallowable costs. The respondent recommends the Council adopt the "30 percent rule" that was contained in 1976 DoD guidance issued by the then Assistant Secretary of Defense (Installations and Logistics) Mr. Dale Babione. The respondent states that this guidance instructed DoD personnel how to interpret the materiality threshold applied to directly associated unallowable costs. The respondent further states that this 1976 guidance established a threshold of 30 percent of total time, over which salary costs are determined to be unallowable and under which further evaluation is required. The respondent asserts that many contractors and contracting officers have successfully implemented this guidance over the past 25 years.

Councils' response: Nonconcur. The Councils believe that a decision on materiality should be made by the contracting officer on a case-by-case basis after consideration of the three factors listed at 31.201-6(e)(1): the actual dollar amount, the cumulative effect of all directly associated costs in

a cost pool, and the ultimate effect on the cost of Government contracts.

The Councils believe that materiality should not be determined based solely on a percentage. For example, 25 percent may have a material impact to the Government for a company in which every employee spends 25 percent of their time on directly associated unallowable costs. Conversely, the impact to the Government may be immaterial if the Government participation in the indirect cost base is small, even if an employee is spending more than 30 percent of his/her time on directly associated unallowable costs. Using a similar analysis, 50 percent may have a material impact to the Government if the total amount involved is large and/or the Government has a large share of the allocation base. Conversely, 50 percent may have an immaterial impact to the Government if the total amount involved is small and/or the Government share of the allocation base is small.

FAR 31.201-6(e)(2)

6. *Comment:* Definition of directly associated cost. Two respondents contend that CAS 405 (Accounting for Unallowable Costs) does not distinguish among types of directly associated costs. They assert that CAS 405 prescribes a general rule of cost recognition, measurement and allocation, which applies to all types of cost, without distinction. They further state that CAS 405 prescribes the following "but for" test: Directly associated cost means any cost which is generated solely as a result of the incurrence of another cost, and which would not have been incurred had the other cost not been incurred. The respondents contend that FAR 31.201-6(e) abandons this "but for" test and substitutes a materiality test for recognizing and measuring the "salary expenses of employees who participate in activities that generate unallowable costs." Accordingly, the respondents believe it is confusing as to whether salaries and expenses are governed by the "but for" test or by a new "materiality" test. Therefore, one respondent recommends amending FAR 31.201-6(e) so that it complies with CAS 405 in the application of the "but for" test and delete the "materiality" test. As an alternative, the other respondent recommends that FAR 31.201-6(e) be amended to establish a rebuttable presumption that material amounts of time devoted to unallowable activities would, in the normal course of business, influence the employee's compensation. Under the respondent's proposal, contractors could rebut the presumption by showing that, in any

individual situation, compensation would not have been affected. For example, under the respondent's revision, compensation would not be affected in the unusual situation of a natural disaster requiring salaried personnel to devote material amounts of effort to unallowable charitable activities during a particular accounting period.

Councils' response: Nonconcur. The Councils note that the current language at FAR 31.201-6(e)(2) is not a "new" materiality test. This language, which was promulgated over twenty years ago, provides contracting personnel and contractors with specific information on when to treat salaries and expenses as directly associated costs. The Councils believe this language should be retained. They also believe that the respondent's proposed alternative language would potentially cause significant increases in the number of disputes due to arguments regarding when compensation is and is not affected by unallowable activities.

7. *Comment:* Illustration. The respondent states that it does not object to the inclusion of an illustration in FAR 31.201-6(e)(2), but if an illustration is to be included, it prefers the one included in CAS 405-60(e). The respondent contends that use of a CAS illustration will avoid potential conflicts in determining materiality.

Councils' response: Nonconcur. The proposed language at FAR 31.201-6(e)(2) is not an illustration, but is instead criteria for determining how to treat salary expenses of employees that participate in activities that generate unallowable costs. The Councils believe it is not appropriate for FAR Part 31 to include illustrations such as those contained in CAS because they would be inconsistent with the overall structure of the FAR, which does not include such illustrations in any other part.

FAR 31.201-6(e)(3)

8. *Comment:* Incorrect reference. Two respondents noted that the reference in 31.201-6(e)(3) is incorrect. The reference should be to paragraphs (e)(1) and (e)(2) of that subsection, rather than (f)(1) and (f)(2).

Councils' response: Concur. There is no paragraph (f)(1) or (f)(2) in FAR 31.201-6. The typographical errors have been corrected in paragraphs (e)(2), and (e)(3).

B. Regulatory Flexibility Act

The Councils do not expect this proposed rule to have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility

Act, 5 U.S.C. 601, *et seq.*, because most contracts awarded to small entities use simplified acquisition procedures or are awarded on a competitive, fixed-price basis, and do not require application of the cost principles and procedures discussed in this rule. An Initial Regulatory Flexibility Analysis has, therefore, not been performed. We invite comments from small businesses and other interested parties. The Councils will consider comments from small entities concerning the affected FAR Part in accordance with 5 U.S.C. 610. Interested parties must submit such comments separately and should cite 5 U.S.C. 601, *et seq.* (FAR case 2004-006), in correspondence.

C. Paperwork Reduction Act

The Paperwork Reduction Act does not apply because the proposed changes to the FAR do not impose information collection requirements that require the approval of the Office of Management and Budget under 44 U.S.C. 3501, *et seq.*

List of Subjects in 48 CFR Part 31

Government procurement.

Dated: September 20, 2004

LAURA AULETTA,

Director, Contract Policy Division.

Therefore, DoD, GSA, and NASA propose amending 48 CFR part 31 as set forth below:

PART 31—CONTRACT COST PRINCIPLES AND PROCEDURES

1. The authority citation for 48 CFR part 31 is revised to read as follows:

Authority: 40 U.S.C. 121(c); 10 U.S.C. chapter 137; and 42 U.S.C. 2473(c).

2. Amend section 31.201-6 by—

- a. Amending paragraphs (a) and (b) by removing "which" and adding "that" in its place each time it appears;
- b. Revising paragraph (c);
- c. Revising the first sentence in paragraph (d);
- d. Amending paragraph (e)(1)(ii) by removing "or" and adding "and" in its place; and
- e. Revising paragraph (e)(3).

The revised text reads as follows:

31.201-6 Accounting for unallowable costs.

* * * * *

(c)(1) The practices for accounting for and presentation of unallowable costs must be those described in 48 CFR 9904.405, Accounting for Unallowable Costs.

(2) Statistical sampling is an acceptable practice for accounting for and presenting unallowable costs provided the following criteria are met:

(i) The statistical sampling results in an unbiased sample that is a reasonable representation of the sampling universe.

(ii) All large dollar value and high risk transactions are separately reviewed for unallowable costs and excluded from the sampling process.

(iii) The statistical sampling permits audit verification.

(3) For the purposes of applying the penalty provisions at FAR 42.709, when statistical sampling is used for accounting for and presenting unallowable costs—

(i) The following amounts must be excluded from any final indirect rate proposal or final statement of costs incurred or estimated to be incurred under a fixed-price incentive contract submitted to the Government:

(A) The amounts projected to the sampling universe for any expressly unallowable costs in the sample.

(B) The amounts projected to the sampling universe for any costs in the sample determined to be unallowable for the contractor before proposal submission.

(ii) Any amounts that are not excluded in accordance with paragraph (c)(3)(i) of this subsection are subject to the penalties provisions at FAR 42.709.

(iii) The provisions of paragraph c)(3)(ii) of this subsection do not apply to the following:

(A) Contracts that are \$500,000 or less.

(B) Fixed-price contracts without cost incentives.

(C) Firm-fixed-price contracts for the purchase of commercial items.

(4) Use of statistical sampling methods for identifying and segregating unallowable costs should be the subject of an advance agreement under the provisions of FAR 31.109. The advance agreement should specify the basic characteristics of the sampling process.

(d) If a directly associated cost is included in a cost pool that is allocated over a base that includes the unallowable cost with which it is associated, the directly associated cost shall remain in the cost pool. * * *

(e) * * *

(3) When a selected item of cost under 31.205 provides that directly associated costs be unallowable, such directly associated costs are unallowable only if determined to be material in amount in accordance with the criteria provided in paragraphs (e)(1) and (e)(2) of this subsection, except in those situations where allowance of any of the directly associated costs involved would be considered to be contrary to public policy.

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