



JUL 22 2003

GSA Office of Governmentwide Policy

MEMORANDUM FOR RONALD POUSSARD  
DIRECTOR  
DEFENSE ACQUISITION REGULATIONS COUNCIL

FROM: RODNEY P. LANTIER, DIRECTOR *Rodney P. Lantier*  
REGULATORY AND FEDERAL ASSISTANCE  
PUBLICATIONS DIVISION

SUBJECT: FAR Case 2002-006, Application of Cost Principles and  
Procedures and Accounting for Unallowable Costs

Attached are comments received on the subject FAR case published at 68 FR 28108;  
May 22, 2003. The comment closing date was July 21, 2003.

<u>Response Number</u>	<u>Date Received</u>	<u>Comment Date</u>	<u>Commenter</u>
2002-006-1	06/05/03	06/05/03	Frank Soda
2002-006-2	07/17/03	07/17/03	DCAA
2002-006-3	07/21/03	07/21/03	NDIA
2002-006-4	07/21/03	07/21/03	WCC
2002-006-5	07/21/03	07/21/03	AIA
2002-006-6	07/22/03	07/22/03	Northrop Grumman

Attachments

2002-006-1



"Soda, Frank"  
<Frank.Soda@dcma.mi  
I>

To: farcase.2002-006@gsa.gov  
CC:  
Subject: Comment on FAR case 2002-006

06/05/2003 09:52 AM

Dear FAR Secretariat:

June 5, 2003

Reference the May 22, 2003 Federal Register on page 28109 of subject FAR case. There in the middle column under item numbered "(3)" is a reference to (f)(1) and (f)(2) of this subsection. I believe this reference is in error. The corrected number 3 should read as follows:

(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, . . . "

This comment does not represent the opinion of any U. S. Government office.

Thank you.

Frank Soda

DEFENSE CONTRACT AUDIT AGENCY  
DEPARTMENT OF DEFENSE  
8725 JOHN J. KINGMAN ROAD, SUITE 2135  
FORT BELVOIR, VA 22060-6219

2002-006-2

IN REPLY REFER TO

PAC 730.8.A.02/2003-02

July 17, 2003

General Services Administration  
FAR Secretariat (MVA)  
Attn: Laurie Duarte  
1800 F Street, NW, Room 4035  
Washington, DC 20405

SUBJECT: FAR Case 2002-006, Application of Cost Principles and Procedures and  
Accounting for Unallowable Costs

Dear Ms. Duarte:

In response to a Federal Register notice dated May 22, 2003, we are providing comments on the proposed rule regarding the use of statistical sampling as a method to identify unallowable costs.

DCAA is concerned that the proposed rule on the use of statistical sampling may cause disputes over the acceptability of the contractor's sampling plan. DCAA believes that the contractor's statistical sampling plan to identify and segregate unallowable costs should be discussed and agreed upon up-front between the contractor and the auditor in order to minimize subsequent disputes over the adequacy of the plan.

Differing interpretations of statistical terms and methodologies used could lead to disputes between the contractor and the government. In addition, if the DCAA auditor determines that the contractor's plan is not acceptable to meet the audit objectives, the auditor will have to develop his/her own statistical sampling plan. This dual sampling would necessarily lead to additional efforts and costs to both the contractor and the government. In accordance with the Generally Accepted Government Auditing Standards (GAGAS), the DCAA auditor must independently establish his/her audit scope to meet the stated audit objective. Determination of the audit scope (e.g., how many transactions of which accounts are to be tested), in any given circumstance, will be affected by the audit risk associated with the contractor being audited. Therefore, the adequacy of a statistical sampling plan for any given contractor varies based on audit risk surrounding the contractor, such as the effectiveness of the contractor's systems of internal controls and the nature of expenses being sampled.

006-2

PAC 730.8.A.02/2003-02

July 17, 2003

SUBJECT: FAR Case 2002-006, Application of Cost Principles and Procedures and  
Accounting for Unallowable Costs

Accordingly, we believe 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, projection, etc.) is essential in order to avoid subsequent disputes over the adequacy of the sampling plan used by the contractor. Such disputes will delay a timely settlement of the contractor's incurred cost submissions and adversely impact the contract close-out process.

We believe that the up-front discussion and agreement on the contractor's statistical sampling plan can easily be accomplished through an advance agreement. The use of advance agreements will protect the interest of the government while allowing flexibility to the contractor for identifying its unallowable costs using statistical sampling measures. Accordingly, we recommend the following provision be added to the proposed coverage at 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.

We appreciate the opportunity to comment on this FAR case. Questions should be directed to Ms. Lydia Funk, Program Manager, Accounting and Cost Principles Division at (703) 767-3250.

Sincerely,

/Signed/

Robert DiMucci  
Assistant Director,  
Policy and Plans



2002-006-3

2111 Wilson Boulevard, Suite 400  
Arlington, Virginia 22201-3061  
Tel: (703) 522-1820 • Fax: (703) 522-1885  
Web page: <http://www.ndia.org>

*The Voice of the Industrial Base*

July 21, 2003

General Services Administration  
FAR Secretariat (MVA)  
1800 F Street, N.W.  
Room 4035  
Washington, D.C., 20405

ATTN: Ms. Laurie Duarte

Subject: FAR Case 2002-006, Application of Cost Principles and Procedures  
And Accounting for Unallowable Costs

Dear Ms. Duarte:

The National Defense Industrial Association (NDIA) is pleased to submit comments on the proposed rule to amend sections of the Federal Acquisition Regulation (FAR) relating to accounting for unallowable costs and application of cost principles and procedures.

NDIA is a non-partisan, non-profit organization with a membership that includes over 1,100 companies – both large and small businesses – and more than 27,000 individuals. NDIA has a specific interest in government policies and practices concerning the government's acquisition of goods and services. Our members, who provide a wide array of goods and services to the government, include some of the nation's largest defense contractors.

Our members concur with the proposed amendment to 31.201-6, *Accounting for Unallowable Costs*. Adding the proposed (c)(2) language ("Statistical sampling is an acceptable practice for accounting and presenting unallowable costs ...") will eliminate existing regulatory ambiguity and will promote uniformity among contractor practices in this area. Accordingly, it should eliminate disputes between auditors and contractors.

Our members believe, however, that the FAR Council is missing an opportunity to codify the 1976 DOD guidance issued by then-Assistant Secretary of Defense (Installations and Logistics) Dale Babione regarding how DOD personnel are to interpret the materiality threshold applied to directly associated unallowable costs. (This guidance has come to be known as the "30 percent rule" because it establishes a threshold of 30 percent of total time, over which salary costs are to be determined to be unallowable and under which further

*"Publishers of National Defense Magazine"*

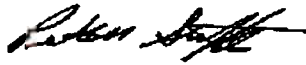
006-3

evaluation is required.) Many contractors and contracting officers have successfully implemented that guidance over the past 25 years, and we encourage incorporation of this guidance into the final rule language.

Our members also concur with the proposed streamlining of 31.204, *Application of Principles and Procedures*, to clarify the language at (b). Further, our members also concur with the proposed additional language at (c) that clarifies that costs incurred as payments under firm-fixed price or fixed-price with economic price adjustment subcontracts are fully allowable when the subcontracts are negotiated in accordance with 31.102.

Our members applaud this effort to streamline and clarify Part 31. It is a good step forward in the continuing effort to identify and remove Part 31 language that is not required by statute. We encourage the FAR Council to continue this process.

Sincerely,



Peter M. Steffes  
Vice President, Government Policy  
National Defense Industrial Association



2002-006-4

One Park Place • Suite 700  
621 Northwest 53rd Street • Boca Raton • Florida 33487  
TELEPHONE: 561.893.0101 • 800.666.5640

July 21, 2003

General Services Administration  
FAR Secretariat (MVA)  
1800 F Street, N.W.  
Room 4035  
Attention Laurie Duarte  
Washington, DC 20405

Re: Comments on FAR Case 2002-006

Dear Ms. Duarte:

This responds to the General Services Administration's (GSA) request for comments in connection with its proposed revision to Federal Acquisition Regulation (FAR) 31.201-6 relating to accounting for unallowable costs and application of cost principles and procedures, as set forth in the Federal Register on May 22, 2003 (FAR Case 2002-006). Pursuant to this Federal Register Notice, comments on FAR Case 2002-006 are due July 21, 2003.

These comments are submitted on behalf of Wackenhut Corrections Corporation (WCC), a leading developer and manager of privatized correctional and detention facilities in the United States. By way of background, WCC designs, constructs and finances state-of-the-art correctional, detention and mental health facilities for the U.S. Department of Justice and the U.S. Department of Homeland Security, as well as state and local government.

WCC fully supports GSA's proposed change to FAR 31.201-6 (c), which we believe will result in reduced disputes between contractors and government administrators. However, WCC encourages GSA to take this opportunity to alleviate a serious inconsistency between the existing regulation and CAS 405, as it applies to "salary expenses of employees."

**I. GSA's Proposed Change To FAR 31.201-6(c) Will Reduce Disputes Between Contractors And Government Administrators**

As you know, FAR 31.201-6 requires contractors to identify and exclude from any billing, claim or proposal, those costs, which are expressly unallowable or mutually agreed to be unallowable directly associated costs. Paragraph (a) of the regulation defines the term "directly associated costs" as "any cost which is

006-4

generated solely as a result of incurring another cost, and which would not have been incurred had the other cost not been incurred." In other words, a "directly associated cost" is itself identified as unallowable by virtue of its being associated with another cost that the FAR has otherwise designated as unallowable.

The regulation, as it is current drafted, states in paragraph (c) that "the practice for accounting for and presentation of unallowable costs must be those described in 48 CFR 9904.405, Accounting for Unallowable Costs." It is our understanding that the above language for paragraph (c) was inserted in 1995 as a means of incorporating, by reference, the policies outlined in Cost Accounting Standard (CAS) 405 for accounting for and presenting unallowable costs.

Under GSA's May 22, 2003 proposed revision, FAR 31.201-6 (c) would be amended to now allow statistical sampling as an acceptable practice for accounting for and presenting unallowable costs. As noted above, WCC fully supports GSA's proposed change to FAR 31.201-6 (c), which we believe will result in reduced disputes between contractors and government administrators. More specifically, we believe that there are often disputes between federal contractors and government administrators regarding the degree of accuracy that federal contractors must use in eliminating "unallowable cost" from indirect cost pools.

From our experience, government officials have ranged from requiring federal contractors to provide "perfect accuracy" to allowing federal contractors to utilize "some type of statistical approach" when accounting for and presenting unallowable cost. In other words, the Defense Contract Audit Agency and individual contracting officers are not always receptive to statistical alternatives when a federal contractor accounts for and presents unallowable cost. GSA's proposed revision to FAR 31.201-6 (c) would sanction the process of statistic sampling and eliminate future disagreements as to whether it is a permissible approach to accounting for and presenting unallowable cost.

Further, large federal contractors, such as WCC, often charge thousands of individual small amounts to indirect cost. To require such federal contractors to then review, annually, each of these individual small amounts translates into an overly burdensome accounting requirement. Under the proposed revision to FAR 31.201-6 (c), however, it is our understanding that a large federal contractor, like WCC, could select a random sample of the small items in its indirect account, research the sample items and then apply the results of the research to the whole universe of items in its indirect account. In other words, WCC could select a sample of 10% of all items in its account under \$500, calculate an



006-4

"unallowable" percentage based on review of the sample -- for example 1.5% -- and then apply the percentage to the entire universe of items under \$500. This process of statistical sampling, which WCC understands would now be an acceptable means of calculating unallowable costs pursuant to GSA's proposed revision to FAR 31.201-6 (c), would translate into a far less burdensome accounting requirement.

## II. Need for Additional Amendment to FAR 31.201-6

While WCC fully supports GSA's proposed change to FAR 31.201-6, we also encourage the FAR Council to make an additional amendment to the regulation, which we believe would alleviate a serious inconsistency between the existing regulation and CAS 405. More specifically, WCC is concerned that FAR 31.201-6 does not correctly implement CAS 405 as it applies to "salary expenses of employees."

As noted above, CAS 405 does not distinguish among types of directly associated costs. Instead, it prescribes a general rule of cost recognition, measurement and allocation, which applies to all types of cost, without distinction. See *General Dynamics Corp.*, ASBCA No. 31359, 92-1 BCA ¶ 24,698, *aff'd on recon.*, 92-2 BCA ¶ 24,992. Accordingly, CAS 405 identifies those costs which would otherwise normally be allowable, but for their relationship to an unallowable cost. As a result of their relationship to an unallowable cost, these otherwise normally allowable costs become unallowable "directly associated costs" under FAR 31.201-6. These costs are then expressly unallowable or mutually agreed to be unallowable directly associated costs.

To identify and measure all directly associated costs, 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." See CAS 405-30 (a) (1). This definition of a directly associated cost is codified in both the current and proposed FAR 31.201-6.

However, in paragraph FAR 31.201-6 (e), this "but for" test outlined in CAS 405 is abandoned. Instead, FAR 31.201-6 (e) prescribes a different test for recognizing and measuring the "salary expenses of employees who participate in activities that generate unallowable costs." More specifically, these costs are "treated as directly associated costs to the extent of the time spent on the proscribed activity, provided the costs are material . . ." Accordingly, it is confusing as to whether "salary and expenses" are governed by the "but for" test or by a new "material"

006-4

test. Further, by using the words "treated as directly associated costs," the regulation suggests that "salary and expenses" do not have to meet the CAS 405 definition of directly associated costs. Accordingly, WCC is concerned that these points of confusion may result in disagreements between contractors and government-contracting officials as to whether costs associated with "salary and expenses" are an allowable or unallowable cost.

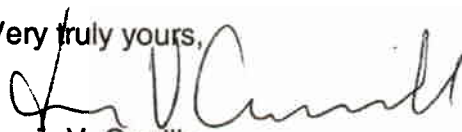
### III. Recommendation

To remedy the inconsistency described above, WCC recommends that the FAR Council amend 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.

In conclusion, WCC supports under the GSA's proposed revision of FAR 31.201-6 (c), which WCC believes will result in reduced disputes between federal contractors and government administrators. However, WCC encourages the FAR Council to take the opportunity to further amend FAR 31.201-6 to reduce the inconsistency between paragraph (e) of that regulation and CAS 405, for which the regulation was drafted to implement.

Thank you for your consideration of these comments.

Very truly yours,



Louis V. Carrillo  
Vice President, Corporate Counsel

2002-006-5



July 21, 2003

General Services Administration  
FAR Secretariat (MVA)  
Attn: Laurie Duarte  
1800 F Street, NW, Room 4035  
Washington, DC 20405

Re: FAR Case 2002-006

Dear Ms. Duarte:

The Aerospace Industries Association (AIA) is pleased to have the opportunity to comment on the proposed rule to amend FAR 31.201-6, Accounting for unallowable costs, and FAR 31.204, Application of principles and procedures.

AIA member companies support the effort to streamline the cost principles in FAR Part 31. The proposed rule amending FAR 31.201-6 and FAR 31.204 are steps in the right direction. While our member companies are in general agreement with the proposed revisions, they offer the following comments and recommendations.

**FAR 31.201-6 Accounting for unallowable costs**

(1) We recommend the removal of proposed paragraph (c) (1) [currently FAR 31.201-6, paragraph (c)]. Non-CAS covered contractors should not be subject to CAS requirements because of their adherence to the FAR cost principles. Further, incorporating such requirements into the FAR by reference results in lowering thresholds for CAS application and is contrary to progressive initiatives such as those undertaken by the DoD Panel on Measurement, Assignment and Allocability Provisions in FAR Part 31, and by the DAR Council in the conduct of the DFARS Transformation Project.

(2) We strongly support the addition of proposed paragraph (c) (2), which adds specific criteria for the use of statistical sampling as a method of identifying unallowable costs. This should help eliminate potential disputes between contractors and auditors.

(3) We agree with the proposed change in paragraph (e) (1) (ii), which substitutes the word "and" for "or." This will improve the process for determining the materiality of directly associated costs.

006-5

Ms. Laurie Duarte  
July 21, 2003  
Page 2

(4) We have no objection to the use in 31.201-6(e) (2) of an illustration on the allowability of salary costs, but if an illustration is to be included, we would prefer the one included in CAS 405-60(e). Use of the CAS illustration will avoid potential conflicts in determining materiality.

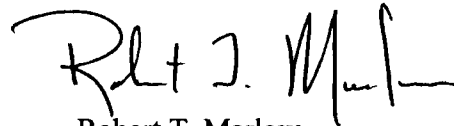
(5) In paragraphs (e) (2) and (e) (3), there are several references to a paragraph (f). There is no paragraph (f) in the proposed or current FAR provisions. Thus, we believe (e) should be inserted wherever there is an (f) reference.

**FAR 31.204 Application of principles and procedures**

We concur that the changes made to paragraphs (b) and (c) improve the readability of this FAR section.

If you have any questions concerning our comments or recommendations, please contact Mr. Dick Powers of my staff. Dick can be reached on (703) 358-1042. His e-mail address is [powers@aia-aerospace.org](mailto:powers@aia-aerospace.org) Thank you for your consideration.

Sincerely,



Robert T. Marlow  
Vice President  
Government Division

2002-006-6

**NORTHROP GRUMMAN**

Northrop Grumman Corporation  
1840 Century Park East  
Los Angeles, California 90067-2199

156-03-FK-001

July 22, 2003

General Services Administration  
FAR Secretariat (MVA)  
1800 F Street, NW., Room 4035  
Attn: Laurie Duarte  
Washington, DC 20405

Reference: FAR Case 2002-006

Dear Ms. Duarte:

Northrop Grumman is pleased to provide comments on the proposed revisions to FAR 31.201-6, Accounting for unallowable costs, and FAR 31.204, Application of principles and procedures.

We have reviewed the response being submitted by the Aerospace Industries Association regarding this proposed rule and, except for its recommendation to remove the language proposed at FAR 31.201-4(c)(1), support the comments included therein.

Regarding the proposed FAR 31.201-4(c)(1) language, we believe retaining a requirement in FAR for all contractors to comply with the provisions in CAS 405 results in more clearly understood and easily applied criteria for accounting for unallowable costs. Also, it precludes there being any perceived difference between CAS and FAR requirements for contractors subject to CAS and creates a more level playing field between all contractors.

Thank you for your consideration. If you should have any questions regarding our response or wish to discuss this subject further, please contact either Frank Knapp or me. Frank can be reached at (310) 229-1323 or via e-mail at [Frank.Knapp@ngc.com](mailto:Frank.Knapp@ngc.com).

/s/

Robert Morales, Corporate Director  
Government Financial Relations and Restructuring Administration  
Northrop Grumman Corporation  
(310) 201-3486



AUG 6 2003

GSA Office of Governmentwide Policy

MEMORANDUM FOR RONALD POUSSARD  
DIRECTOR  
DEFENSE ACQUISITION REGULATIONS COUNCIL

FROM: RODNEY P. LANTIER, DIRECTOR  
REGULATORY AND FEDERAL ASSISTANCE  
PUBLICATIONS DIVISION

SUBJECT: FAR Case 2002-006, Application of Cost Principles and  
Procedures and Accounting for Unallowable Costs

Attached are additional comments received on the subject FAR case published at 68  
FR 28108; May 22, 2003. The comment closing date was July 21, 2003.

<u>Response Number</u>	<u>Date Received</u>	<u>Comment Date</u>	<u>Commenter</u>
2002-006-7	07/21/03	08/05/03	Sandia National Laboratories
2002-006-8	07/21/03	08/05/03	DoD/IG

Attachments



2002-006-7  
**Sandia National Laboratories**

Operated for the U.S. Department of Energy by

**Sandia Corporation**

P.O. Box 5800

Albuquerque, NM 87185-5800

Phone: (505) 284-4345

Fax: (505) 284-4358

Internet: gzura@sandia.gov

**Gary B. Zura**

Deputy for Contracts and Policy to the Vice President/CFO

July 21, 2003

Refer to: 03-309-SNL-7/21/03

General Services Administration  
FAR Secretariat (MVA)  
1800 F. Street NW, Room 4035  
Washington, DC 20405

Attention: Laurie Durate

Subject: FAR Case 2002-006

Dear Ms. Durate:

The use of statistical sampling and extrapolated amounts to determine unallowable cost is a source of considerable concern to Sandia Corporation, a wholly owned subsidiary of Lockheed Martin Corporation under contract to the Department of Energy (DOE) to manage and operate Sandia National Laboratories. Unlike the vast majority of government contractors managing and operating (M&O) Federally Funded Research & Development Centers under DOE's sole sponsorship are confronted with an environment totally dominated by a single government customer. The general absence of (1) other customers of any appreciable size, and (2) a mix of contract types, mitigates the need for the establishment of numerous discrete pools to ensure the proper allocation of cost to final cost objectives. The maintenance of a less complicated and less costly accounting system is perfectly adequate for the parties from a cost allocation perspective. No matter how many indirect pools are established and maintained, the end result will not be materially different. The vast majority of expenses still are going to end up being charged to the same government customer.

The problem surfaces when cost allowability, rather than allocability, is at issue. DOE M&O contractors submit a statement of all cost incurred and claimed at the end of each fiscal period. Statistical samples of cost claimed via a particular financial process (i.e., employee expense vouchers, travel vouchers, check requests, procurement cards, etc.) are performed to determine the validity of system controls. Lately, the government customer has adopted the position that the same sample can be used to project the total unallowable costs for the universe of cost claimed via the financial process under review. Unfortunately, while these costs may be "homogeneous" from a cost allocability perspective, they are quite disparate vis-à-vis the underlying DEAR/FAR cost principles. For example, employee expense vouchers will typically include a myriad of different expenses (i.e., equipment, meals, transportation, personal property damage, conference registration fees, training costs, etc.). Sandia acknowledges that statistical sampling is a valid audit technique when employed in appropriate circumstances. We can support using statistical sampling to project unallowable costs in connection with discrete pools (marketing/selling, depreciation, taxes, etc.) where the number of differing cost elements is limited. However, we concurrently object 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.

We understand that it may be impractical to formally address each individual circumstance in which statistical sampling is an appropriate technique for accounting for unallowable cost. Instead, we recommend that FAR 31.201-6 be revised to include a requirement that a mutual agreement be a precondition to the actual use of this audit technique. While it can be argued that this requirement is implicit in the term "acceptable practice" set forth in subparagraph (c)(2), we submit that numerous disagreements can be avoided by simply revising subparagraph (c)(2) as follows:

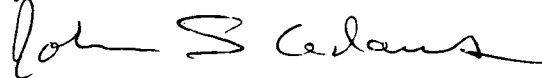
"(2) Applied in accordance with a mutual agreement between the government and contractor, statistical sampling is an acceptable practice for accounting and presenting unallowable costs provided----"

Please address any questions concerning these comments to John Adams at (505) 284-4347.

Very truly yours,

SANDIA CORPORATION

By



for Gary B. Zura, Level II Manager  
Deputy for Contracts and Policy to the  
Vice President/CFO  
Department 10001/MS-0180

Copy to:

MS-0180 A Peterson (10001)  
MS-0180 C Gallipoli (10001)  
MS-0180 J Adams (10001)  
MS-0180 SNL Outgoing File (10001)



006-7



# Federal Register

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Thursday,  
May 22, 2003

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**Part V**

**Department of  
Defense  
General Services  
Administration  
National Aeronautics  
and Space  
Administration**

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**48 CFR Part 31  
Federal Acquisition Regulation;  
Application of Cost Principles and  
Procedures and Accounting for  
Unallowable Costs; Proposed Rule**

006-7

## DEPARTMENT OF DEFENSE

GENERAL SERVICES  
ADMINISTRATIONNATIONAL AERONAUTICS AND  
SPACE ADMINISTRATION

## 48 CFR Part 31

[FAR Case 2002-006]

RIN: 9000-AJ65

Federal Acquisition Regulation;  
Application of Cost Principles and  
Procedures and 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) sections relating to accounting for unallowable costs and application of cost principles and procedures.

**DATES:** Interested parties should submit comments in writing on or before July 21, 2003 to be considered in the formulation of a final rule.

**ADDRESSES:** Submit written comments to—General Services Administration, FAR Secretariat (MVA), 1800 F Street, NW., Room 4035, Attn: Laurie Duarte, Washington, DC 20405.

Submit electronic comments via the Internet to—[farcase.2002-006@gsa.gov](mailto:farcase.2002-006@gsa.gov).

Please submit comments only and cite FAR case 2002-006 in all correspondence related to this case.

**FOR FURTHER INFORMATION CONTACT:** The FAR Secretariat, Room 4035, GS Building, Washington, DC, 20405, at (202) 501-4755 for information pertaining to status or publication schedules. For clarification of content, contact Mr. Edward Loeb at (202) 501-0650. Please cite FAR case 2002-006.

## SUPPLEMENTARY INFORMATION:

## A. Background

The DoD Director of Defense Procurement 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, related to cost measurement, assignment, and allocation to evaluate the need for each specific requirement in light of the evolution of generally accepted

accounting principles and experience gained from implementation.

The Director of Defense Procurement announced a series of public meetings in the *Federal Register* at 66 FR 13712, March 7, 2001 (with a "correction to notice" published in the *Federal Register* at 66 FR 16186, March 23, 2001). Attendees at the public meetings (held on April 19, 2001, May 10-11, 2001, and June 12, 2001) 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 public comments; identified potential changes to the FAR; and submitted several reports, including draft proposed rules for consideration by the Councils.

The Councils have reviewed the reports related to FAR 31.201-6, Accounting for unallowable costs, and FAR 31.204, Application of principles and procedures, and propose the following revisions:

- Add paragraph (c)(2) to FAR 31.201-6 to provide specific criteria on the use of sampling as a method to identify unallowable costs and the acceptability of contractor sampling methods.
- Revise the current paragraph (b) of FAR 31.204, which addresses the allowability of subcontract costs, to clarify the language.
- Make a number of editorial changes.

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.

## 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 that are 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 31 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 2002-006), 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: May 16, 2003.

Laura G. Smith,

Director, Acquisition 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. Revise section 31.201-6 to read as follows:

## 31.201-6 Accounting for unallowable costs.

(a) Costs that are expressly unallowable or mutually agreed to be unallowable, including mutually agreed to be unallowable directly associated costs, shall be identified and excluded from any billing, claim, or proposal applicable to a Government contract. A directly associated cost is any cost that is generated solely as a result of incurring another cost, and that would not have been incurred had the other cost not been incurred. When an unallowable cost is incurred, its directly associated costs are also unallowable.

(b) Costs that specifically become designated as unallowable or as unallowable directly associated costs of unallowable costs as a result of a written decision furnished by a contracting officer shall be identified if included in or used in computing any billing, claim, or proposal applicable to a Government contract. This identification requirement applies also to any costs incurred for the same purpose under like circumstances as the costs specifically identified as unallowable under either this paragraph or paragraph (a) of this subsection.

(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 and

006-7

presenting unallowable costs provided—

(i) The statistical sampling results in an unbiased sample that accurately represents the sampling universe; and

(ii) The statistical sampling permits audit verification.

(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. Since the unallowable costs will attract their allocable share of costs from the cost pool, no further action is required to assure disallowance of the directly associated costs. In all other cases, the directly associated costs, if material in amount, must be purged from the cost pool as unallowable costs.

(e)(1) In determining the materiality of a directly associated cost, consideration should be given to the significance of—

(i) The actual dollar amount; (ii) The cumulative effect of all directly associated costs in a cost pool; and

(iii) The ultimate effect on the cost of Government contracts.

(2) Salary expenses of employees who participate in activities that generate unallowable costs shall be treated as directly associated costs to the extent of the time spent on the proscribed activity, provided the costs are material

in accordance with paragraph (f)(1) of this subsection (except when such salary expenses are, themselves, unallowable). The time spent in proscribed activities should be compared to total time spent on company activities to determine if the costs are material. Time spent by employees outside the normal working hours should not be considered except when it is evident that an employee engages so frequently in company activities during periods outside normal working hours as to indicate that such activities are a part of the employee's regular duties.

(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 (f)(1) and (f)(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.

3. Amend section 31.204 in the first sentence of paragraph (a) by removing "shall be allowed" and adding "are allowable" in its place; revising paragraph (b); and redesignating paragraph (c) as paragraph (d) and adding a new paragraph (c) to read as follows:

**31.204 Application of principles and procedures.**

\* \* \* \* \*

(b)(1) For the following subcontract types, costs incurred as reimbursements or payments to a subcontractor are allowable to the extent the reimbursements or payments are for costs incurred by the subcontractor that are consistent with part 31:

- (i) Cost-reimbursement.
- (ii) Fixed-price incentive.
- (iii) Price redeterminable (*i.e.*, fixed-price contracts with prospective price redetermination and fixed-ceiling-price contracts with retroactive price redetermination).

(2) The requirements of paragraph (b)(1) of this section apply to any tier above the first firm-fixed-price subcontract or fixed-price subcontract with economic price adjustment provisions.

(c) Costs incurred as payments under firm-fixed-price subcontracts or fixed-price subcontracts with economic price adjustment provisions or modifications thereto, for which subcontract cost analysis was performed, are allowable if the price was negotiated in accordance with 31.102.

\* \* \* \* \*



INSPECTOR GENERAL  
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2002-006-8

JUL 17 2003

Ms. Laurie Duarte  
General Services Administration  
FAR Secretariat (MVA)  
1800 F Street, NW, Room 4035  
Washington, DC 20405

Dear Ms. Duarte:

We have reviewed the proposed Federal Acquisition Regulations (FAR) Case No. 2002-006, "Application of Cost Principles and Procedures and Accounting for Unallowable Costs," and we have the following comments.

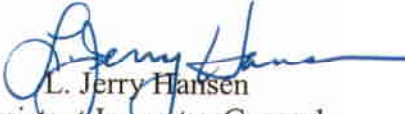
We disagree with the proposed amendment to FAR 31.201-6(c)(2). Statistical sampling should not replace accounting policies and procedures for identifying and segregating unallowable costs when the costs are initially incurred and recorded. Initial identification of unallowable costs is necessary to meet 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, we recommend adding the following underlined text at FAR 31.201-6(c)(2):

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, provided-

To avoid disputes involving the acceptability of a contractor's statistical sampling plan, we recommend the use of an advance agreement. Differing interpretations of statistical terms and methodologies used could lead to disputes between the contractor and the government. These disputes could result in delays in settling contractor's incurred cost submissions and contract close-out. Accordingly, we recommend a third paragraph be added to the proposed coverage at 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.

Thank you for the opportunity to comment on the proposed rule. If you have any questions, please contact Mr. Eric Broderius at (703) 604-8755.

  
L. Jerry Hansen  
Assistant Inspector General  
for Inspections and Policy



AUG 7 2003

MEMORANDUM FOR RONALD POUSSARD  
DIRECTOR  
DEFENSE ACQUISITION REGULATIONS COUNCIL

FROM:  RODNEY P. LANTIER, DIRECTOR  
REGULATORY AND FEDERAL ASSISTANCE  
PUBLICATIONS DIVISION

SUBJECT: FAR Case 2002-006, Application of Cost Principles and  
Procedures and Accounting for Unallowable Costs

Attached is an additional comment received on the subject FAR case published at 68 FR 28108; May 22, 2003. The comment closing date was July 21, 2003.

<u>Response Number</u>	<u>Date Received</u>	<u>Comment Date</u>	<u>Commenter</u>
2002-006-9	08/06/03	07/25/03	ABA

2002-006-9



AMERICAN BAR ASSOCIATION

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2002-2003

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July 25, 2003

General Services Administration  
FAR Secretariat (MVA)  
1800 F Street, NW  
Room 4035  
Washington, DC 20405

Attention: Ms. Laurie Duarte

**Re: FAR Case 2002-006;  
Proposed Rule: Application of Cost Principles and Procedures and  
Accounting for Unallowable Costs;  
68 Fed. Reg. 28108, May 23, 2003**

Dear Ms. Duarte:

On behalf of the Section of Public Contract Law of the American Bar Association ("the Section"), I am submitting comments on the above-referenced matter.<sup>1</sup> The Section consists of attorneys and associated professionals in private practice, industry, and Government service. The Section's governing Council and substantive committees contain members representing these three segments to ensure that all points of view are considered. In this manner, the Section seeks to improve the process of public contracting for needed supplies, services, and public works.

<sup>1</sup> The Honorable Mary Ellen Coster Williams, Chair of the ABA Section of Public Contract Law, has recused herself on this matter, did not participate in the Section's consideration of these comments, and abstained from voting to approve and send this letter. Similarly, Council Member Daniel I. Gordon has recused himself on this matter and did not participate in either the preparation or approval of these comments.

2002-006-9

The Section is authorized to submit comments on acquisition regulations under special authority granted by the Association's Board of Governors. The views expressed herein have not been approved by the House of Delegates or the Board of Governors to the American Bar Association and, therefore, should not be construed as representing the policy of the American Bar Association.

The proposed rule would amend FAR 31.201-6, "Accounting for Unallowable Costs," to recognize that statistical sampling is an acceptable practice for accounting for and presenting unallowable costs, subject to certain conditions and restraints. The Section supports the proposed change to FAR 31.201-6(c) because it should have a positive impact in reducing the number of disputes between contractors and government administrators.

In reviewing FAR 31.201-6, however, the FAR Council has not addressed a fundamental inconsistency between that provision and Cost Accounting Standard ("CAS") 405. FAR 31.201-6 states that it implements CAS 405. See FAR 31.201-6(c). Nevertheless, that is simply not the case with respect to one category of "directly associated cost" – "salary expenses of employees." See FAR 31.201-6(e)(2). CAS 405 does not distinguish among types of directly associated costs. It prescribes a general rule of cost recognition, measurement, and allocation that applies to all types of cost, without distinction. *General Dynamics Corp.*, ASBCA No. 31359, 92-1 BCA ¶ 24,698, *aff'd on recon.*, 92-2 BCA ¶ 24,992. Thus, CAS 405 identifies otherwise normally allowable costs that, by virtue of their relationship to an unallowable cost, may become unallowable "directly associated costs" if the test for cost recognition and measurement is met. For example, plant electricity costs – normally an allowable cost – could under the circumstances prescribed by CAS 405 become associated with an unallowable cost, such as lobbying costs, and thus become unallowable to the extent associated with the unallowable lobbying. The same is true of salaries of indirect cost personnel that are normally an allowable cost.

CAS 405 prescribes a "but for" test for the identification and measurement of *all* directly associated costs:

*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. CAS 405-30(a)(1).

Both the current and proposed FAR 31.201-6(a) recognize and confirm this CAS definition of a directly associated cost.

2002-006-9

association with another cost, with respect to the single case of “salary expenses.” With respect to salary expenses, FAR 31.201-6(e) provides that such costs shall be “treated as directly associated costs” provided the costs are “material,” whether or not the but for test is met. The provision pointedly does not state that such salary costs *are* directly associated costs, but uses the words “*treated as* directly associated costs,” thus recognizing that they do not meet the CAS 405 definition of directly associated costs. CAS 405 preempts the field and governs the issue because such costs, normally allowable in their own right, are directly associated with another (unallowable) cost. . In this respect, both the current and proposed FAR 31.201-6 are in conflict with CAS 405.

The predecessor of FAR 31.201-6(e) was promulgated on February 15, 1982, at the conclusion of a lengthy administrative process extending back to the enactment of CAS 405 on September 6, 1973. This process was characterized by substantial disagreement of the ASPR and DAR drafters with the test prescribed for directly associated costs in CAS 405 as applied to salary costs. The 1982 promulgation of DAR 15-201.6 did not resolve this controversy, but in fact embedded the conflict in the language of the regulation. This all-but-identical language exists in FAR 31.201-6(e) today.<sup>2</sup> The regulation thus embodies a twofold inconsistency: (1) it is internally inconsistent as between paragraphs (a) and (e); and (2) paragraph (e) is inconsistent with CAS 405.

The FAR Council could remove these inconsistencies in a number of ways, most notably by amending FAR 31.201-6 to comply with CAS 405 in the application of the but for test and by deleting the substitute materiality test. Nevertheless, the FAR and its predecessors’ long-standing concern with salary cost as an item requiring special consideration<sup>3</sup> appears to justify a different approach to achieve the same goal of resolving a conflict with CAS. Accordingly, the Section suggests that the FAR Council amend paragraph (e) of 31.201-6 to establish a rebuttable presumption that material amounts of time devoted to unallowable activities would in the normal course influence the employee’s compensation.

Such a presumption appears to underlie existing regulation, but it is irrebuttable as currently stated and thus creates the conflict with CAS 405. Under the Section’s proposed revision, contractors could rebut the presumption by showing that, in any individual situation, compensation would not have been affected. For example, compensation would not be affected in the unusual situation of a natural disaster

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<sup>2</sup> A 2002 article in the *Public Contract Law Journal* summarized the administrative history of the regulation. See 31 Pub. Contr. L. J. 479-512 (2002).

<sup>3</sup> *Id.*, at 481-85. In 1971, DoD promulgated ASPR 15-205.6(j) addressing compensation costs associated with unallowable activities.



2002-006-9

requiring salaried contractor personnel to devote material amounts of effort to unallowable charitable activities during a particular accounting period.

Such an amendment, in our opinion, would remove the inconsistencies both within the current regulation and between FAR and CAS, and would give proper recognition to deeply engrained policies of the FAR and its predecessor regulations. Moreover, permitting contractor rebuttal of the presumption would not complicate the determination of allowable cost any more than is currently the case in attempting to apply the amorphous tests for "materiality" in FAR 31.201-6(e).

The Section appreciates the opportunity to provide these comments and is available to provide additional information or assistance as you may require.

Sincerely,



Hubert J. Bell, Jr.

Chair-Elect, Section of Public Contract Law

cc: Mary Ellen Coster Williams  
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