

# PRATT'S GOVERNMENT CONTRACTING LAW REPORT

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## The Cost Corner

# Government Contracts Cost and Pricing: A Brief Overview of the Regulatory Landscape

*By Keith Szeliga\**

*Welcome to the Cost Corner. This is the first in a series of columns exploring the complex cost and pricing regulations that apply to government contractors. This first column provides an overview of the regulatory framework and its rationale. Subsequent columns will explain specific aspects of the regulations in further detail and provide periodic updates on new developments.*

Most industries in the United States are not subject to cost and pricing regulations. Government contracting is one of the few exceptions.

In the commercial marketplace, prices are determined primarily by supply and demand. A seller's cost influences the price it will be willing to accept for its products and services. However, parties rarely negotiate price based on the seller's actual or estimated cost of performance. Most sellers are unwilling to share cost and pricing data because they believe doing so would place them at an unfair competitive disadvantage and hinder their ability to charge higher prices to certain classes of customers. Buyers do not insist on obtaining costs data because, in most cases, their interests are protected by robust competition.

Government contracts are different. The government buys many products and services for which a commercial marketplace does not exist. Without adequate price competition, the government requires cost and pricing data to determine whether a seller's price is fair and reasonable. The government also funds many projects that are large, complex, and undefined. These projects can impose significant risk on the seller. Rather than paying a large risk premium, the government frequently enters into flexibly priced contracts in which the contractor's compensation depends, at least in part, on its actual cost of performance.

When parties negotiate price based on cost or enter into flexibly priced contracts, they require a common understanding of what cost or pricing data the seller is required to disclose, which costs the buyer is willing to pay, and how those costs will be measured and allocated to contracts. The government typically does not negotiate these terms. Instead, it has adopted complex statutes and regulations that impose them unilaterally on contractors.

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## TINA

First, the Truthful Cost or Pricing Data Statute,<sup>1</sup> commonly referred to by its prior name, the Truth in Negotiations Act (TINA), defines the contractor's obligation to disclose cost or pricing data to the government. Congress enacted TINA in 1962 in response to General Accounting Office (GAO) reports of contractors receiving "unwarranted profits because the data used in establishing target costs or prices were inaccurate, incomplete, or out of date."<sup>2</sup> TINA is intended to "level the playing field" by providing government negotiators the same cost or pricing data available to contractors.

Subject to certain exceptions, TINA and its implementing regulations require contractors to disclose accurate, complete, and current cost or pricing data to the government.<sup>3</sup> Cost or pricing data include all facts that "a prudent buyer or seller would reasonably expect to affect price negotiations significantly."<sup>4</sup> Cost or pricing data are not limited to historical accounting data; they include all the facts that can be reasonably expected to contribute to the soundness of estimates of future costs and to the validity of determinations of costs already incurred.<sup>5</sup>

Examples of cost or pricing data include vendor quotations, nonrecurring costs, information on changes in production methods or purchasing volume, data supporting projections of business prospects and objectives related to operations cost, unit-cost trends such as those associated with labor efficiency, make-or-buy decisions, estimated resources to attain business goals, and information on management decisions that could have a significant bearing on costs.<sup>6</sup> Cost or pricing data do not include pure judgments but they do include factual information upon which judgments are based and judgments that are so inextricably intertwined with facts that they cannot be segregated.<sup>7</sup>

TINA applies to most types of acquisitions (including prime contracts and subcontracts) with a value greater than or equal \$2 million.<sup>8</sup> There are exceptions consistent with the purpose of the statute. For example, the government is prohibited from requiring certified cost or pricing data when

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<sup>1</sup> 41 U.S.C. §§ 3501-3509.

<sup>2</sup> S. Rep. No. 1884, at 3 (1962).

<sup>3</sup> 41 U.S.C. § 3502(b).

<sup>4</sup> 41 U.S.C. § 3501(a)(1); FAR 2.101.

<sup>5</sup> FAR 2.101.

<sup>6</sup> FAR 2.101.

<sup>7</sup> 41 U.S.C. § 3501(a)(1); FAR 2.101.

<sup>8</sup> 41 U.S.C. § 3502(a)(1); FAR 15.403-4(a)(1).

purchasing commercial products or services, when entering into a fixed-price contract based on adequate price competition, and when prices are set by law or regulation.<sup>9</sup> Cost or pricing data are not required in the first two instances because the government can rely on market forces to establish price reasonableness. In addition, requiring cost or pricing data from contractors whose primary business is commercial would discourage those contractors from doing business with the government. Cost or pricing data is not required when prices are set by law or regulation because there is no possibility of price negotiations.

The failure to provide accurate, complete, and current cost or pricing data, when required, can have significant consequences for contractors. If, after award, certified cost or pricing data are found to be inaccurate, incomplete, or not current, the government is entitled to a price adjustment, including profit or fee, equal to the amount by which the price was increased because of the defective data.<sup>10</sup> The government can also assess penalties if it determines that the contractor knowingly submitted defective cost or pricing data.<sup>11</sup> Defective cost or pricing data also have the potential to expose a contractor to liability under the False Claims Act (FCA), which imposes treble damages and penalties on contractors that knowingly submit or cause another to submit false or fraudulent claims to the government.<sup>12</sup>

## FAR

Second, the Federal Acquisition Regulation (FAR) Cost Principles, codified at FAR Part 31, define the costs that will be reimbursed under flexibly priced contracts and considered in the negotiation and modification of fixed price contracts. To be allowable, a cost must be (1) reasonable, (2) allocable to the contract, (3) accounted for in accordance with the Cost Accounting Standards (CAS), if applicable, and otherwise in accordance with generally accepted accounting principles and practices (GAAP), (4) permitted by the terms of the contract, and (5) not limited by the specific cost principles set forth in FAR Subpart 31.2.<sup>13</sup>

- A cost is reasonable if the nature and amount of the cost does not exceed that which a prudent person would incur in the conduct of

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<sup>9</sup> 41 U.S.C. § 3503(a)(1); FAR 15.403-1(b).

<sup>10</sup> 41 U.S.C. § 3506(a); FAR 15.407-1(b); FAR 52.215-10(a).

<sup>11</sup> 41 U.S.C. § 3507(a); FAR 15.407-1(b)(7); FAR 52.215-10(d).

<sup>12</sup> 31 U.S.C. §§ 3729-3733.

<sup>13</sup> FAR 31.201-2.

competitive business.<sup>14</sup> The test focuses on whether the cost is of a type that a prudent business person would incur and whether the amount is consistent with fair market value.

- Allocability is an accounting concept. A cost is allocable to a contract if it is incurred specifically for the contract, if it benefits both the contract and other work, or if it is necessary to the overall operation of the contractor's business.<sup>15</sup>
- The Cost Accounting Standards (CAS),<sup>16</sup> discussed below, establish rules for measuring, assigning, and allocating costs to contracts.
- An otherwise allowable cost may be made prohibited by the terms of a government contract.<sup>17</sup> For example, even a cost expressly allowable under the cost principles may be disallowed if the contractor incurs costs in excess of the contract's estimated cost without a modification adding funding to the contract.<sup>18</sup>
- Despite a determination that a cost may be reasonable and allocable, the cost may nonetheless be unallowable if it is identified as such by statute or regulation. In this regard, the cost principles applicable to commercial organizations identify numerous categories of costs that are unallowable, including, for example, entertainment costs,<sup>19</sup> fines and penalties,<sup>20</sup> interest,<sup>21</sup> and alcohol.<sup>22</sup>

Unallowable costs must be identified and excluded from billings, claims, and proposals.<sup>23</sup> Charging expressly unallowable costs can result in fines and penalties.<sup>24</sup> Contractors that charge unallowable costs knowingly or recklessly also may be subject to liability under the False Claims Act, discussed above.

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<sup>14</sup> FAR 31.201-3(a).

<sup>15</sup> FAR 31.201-4.

<sup>16</sup> 48 C.F.R. Part 9904.

<sup>17</sup> FAR 31.201-2(a)(4).

<sup>18</sup> FAR 52.232-20(d).

<sup>19</sup> FAR 31.205-14.

<sup>20</sup> FAR 31.205-15.

<sup>21</sup> FAR 31.205-20.

<sup>22</sup> FAR 31.205-51.

<sup>23</sup> FAR 31.201-6.

<sup>24</sup> 10 U.S.C. § 3743; 41 U.S.C. § 4303; FAR 42.709; FAR 52.242-3.

## CAS

Third, the CAS, codified at 48 C.F.R. Chapter 99, consist of nineteen standards promulgated by the Cost Accounting Standards Board (CASB) to ensure uniformity and consistency in the measurement, assignment, and allocation costs under government contracts and subcontracts. The most fundamental CAS requirements relate to consistency in estimating, accumulating, and reporting costs (CAS 401), consistency in allocating costs incurred for the same purpose (CAS 402), accounting for unallowable costs (CAS 405), and cost accounting periods (CAS 406).<sup>25</sup> The remaining CAS focus on specific types of costs, such as depreciation,<sup>26</sup> employee compensation and benefits,<sup>27</sup> general and administrative expense,<sup>28</sup> and research and development costs.<sup>29</sup>

The CAS apply to a narrower set of government contracts and subcontracts than TINA and the FAR Cost Principles. Exemptions from CAS coverage include, among other things, government contracts and subcontracts with an award value less than \$2 million, contracts and subcontracts in which the price is set by law or regulation, contracts and subcontracts for commercial products and services, and fixed-price contracts and subcontracts awarded on the basis of adequate price competition.<sup>30</sup> In addition, the CAS do not apply government contracts and subcontracts with an award value below \$7.5 million unless and until a contractor has received \$7.5 million CAS-covered “trigger” contract.<sup>31</sup>

There are two types of CAS coverage. Full CAS coverage applies to contractors that receive a single CAS-covered award of \$50 million or more or received \$50 million or more in net CAS-covered awards in the preceding cost accounting period.<sup>32</sup> Full coverage requires a contractor to comply with all nineteen of the CAS and to submit a CAS disclosure statement providing a detailed explanation of its cost accounting practices.<sup>33</sup> Contractors having CAS-covered contracts that do not meet either of these \$50 million thresholds

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<sup>25</sup> 48 C.F.R. §§ 9904.401, 9904.402, 9904.405, 9904.406.

<sup>26</sup> 48 C.F.R. § 9904.409.

<sup>27</sup> 48 C.F.R. §§ 9904.408, 9904.412, 9904.413, 9904.415.

<sup>28</sup> 48 C.F.R. §§ 9904.403, 9904.410.

<sup>29</sup> 48 C.F.R. § 9904.420.

<sup>30</sup> 48 C.F.R. § 9903.201-1.

<sup>31</sup> 48 C.F.R. § 9903.201-1(7).

<sup>32</sup> 48 C.F.R. § 9903.201-2(a).

<sup>33</sup> 48 C.F.R. § 9903.202-1.

may elect modified CAS coverage.<sup>34</sup> Modified CAS coverage only requires compliance with four of the nineteen CAS, specifically CAS 401, CAS 402, CAS 405, and CAS 406.<sup>35</sup>

CAS-covered contracts include clauses that entitle the government to recover increased costs incurred by the government if a contractor fails to comply with the applicable CAS, fails to consistently follow its disclosed or established cost accounting practices, or unilaterally changes its cost accounting practices.<sup>36</sup> The FAR includes detailed requirements and procedures for calculating the cost impact of a noncompliance or unilateral change to the government.<sup>37</sup>

## CONCLUSION

The statutes and regulations discussed above – TINA, the FAR Cost Principles, and the CAS – are the primary sources of cost and pricing requirements for government contractors. Subsequent columns will focus on those regulations. However, columns also will address other cost and pricing topics, including, for example, the government’s selection of contract type, audit rights, and obligations with respect to cost or price analysis.

However, columns also will address other cost and pricing topics, including, for example, the government’s selection of contract type, audit rights, and obligations with respect to cost or price analysis.

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The next installment of the Cost Corner will provide a more detailed explanation of TINA, focusing on the scope of the contractor’s disclosure obligations, the limitation on defenses available under the statute, and the government’s remedies for the submission of defective cost or pricing data.

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<sup>34</sup> 48 C.F.R. § 9903.201-2(b).

<sup>35</sup> 48 C.F.R. § 9903.201-2(b).

<sup>36</sup> FAR 52.230-2; FAR 52.230-6.

<sup>37</sup> FAR 52.230-6.