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# FAR Part 31 Cost Principles: When Do They Apply to Negotiated Fixed-Price Contracts?

## Introduction

The FAR Cost Principles apply to fixed-price negotiated contracts only in specific circumstances pre- and post-award. It is these nuances in the regulation that can lead to their potential misapplication, confusion, and/or additional outside inquiry, especially in the proposal phase of the

contract lifecycle. For contractors, even in instances when FAR 31 applies, the goal in the proposal phase is a negotiation based on price, not cost.

There has long been significant scrutiny of contractor pricing under federal contracts — and that has been an ongoing trend, particularly with defense spending. Yet, despite applicable regulations, Defense Contract Audit Agency (DCAA) — or cognizant audit agency — proposal audits, and other enforcement mechanisms, the complex nature of government contracting requirements coupled with economic pressures portend this type of inquiry to continue.

While each procurement brings with it different facts and circumstances, one discrete question that has led to much confusion, especially during the pre-award contracting stage, is: “Do the Federal Acquisition Regulation (FAR) Part 31 Cost Principles apply to fixed-price contract negotiations?” Though the answer to that question is fact-specific, it is important to provide clarity and explain the circumstances where the Cost Principles do and do not apply to negotiated fixed-price contracts under FAR Part 15, particularly as it pertains to “price” negotiation.

## Applicability of FAR Part 31 Cost Principles

Fixed-price contracts for commercial items or services are intended to be awarded based on a negotiated price without evaluating separate cost elements and proposed profit. For these types of awards, FAR Part 31 - Contract Cost Principles and Procedures is not a consideration. FAR Part 31 is intended for use in negotiations of fixed-price contracts only where cost analysis is performed or negotiation is based on cost. (FAR 31.102.) While many fixed-price contract negotiations do not warrant cost analysis and are not based on cost, such circumstances do often apply to sole source procurements and other fixed-price awards subject to the Truthful Cost or Pricing Data Act (formerly the Truth in Negotiations Act or TINA).

However, FAR 31 is clear that even in cases where cost analysis is utilized, the analysis of individual cost elements is only applicable to aid contracting officers in one thing: determining a total price that is fair and reasonable. Therefore, despite the applicability of FAR Part 31 Cost Principles in this scenario and the propensity of a contracting officer to home in on specific costs elements once divulged, FAR Part 31 does not restrict a contractor’s ability to ultimately negotiate and agree to a total fixed-price that meets the company’s end price objectives. Nor does it preclude a contracting officer from agreeing to a similar position.

# Additional FAR Regulatory Guidance

By their very nature, fixed-price contracts provide “for a price that is not subject to any adjustment on the basis of the contractor’s cost experience in performing the contract.” (FAR 16.202-1.) When determining the appropriate method to evaluate a contractor’s proposed price, contracting officers rely on guidance at FAR 15.305 Proposal evaluation, which states in (a)(1), Cost or price evaluation: “Normally, competition establishes price reasonableness. Therefore, when contracting on a firm-fixed-price or fixed-price with economic price adjustment basis, comparison of the proposed prices will usually satisfy the requirement to perform a price analysis, and a cost analysis need not be performed. In limited situations, a cost analysis may be appropriate to establish reasonableness of the otherwise successful offeror’s price (see 15.403-1(c)(1)(i)(C)).”

Furthermore, the government may use various price analysis techniques and procedures to ensure a fair and reasonable price as described at FAR 15.404-1(b). These may include but are not limited to:

1. Comparison of proposed prices received in response to the solicitation.
2. Comparison of previously proposed prices and previous government and commercial contract prices with current proposed prices.
3. Use of parametric estimating techniques.
4. Comparison with competitive published price lists.
5. Comparison with independent cost estimates.
6. Comparison of proposed prices with prices obtained through market research for the same or similar items.
7. Evaluation of data other than certified cost or pricing data provided by the offeror.

The first two price analysis techniques are the preferred techniques and do not include any examination of cost. However, the contracting officer may determine that information on competitive proposed prices or previous contract prices is not available or is insufficient to determine that the price is fair and reasonable. If so, the contracting officer may use any of the

remaining techniques as appropriate to the circumstances, which includes cost analysis.

As such, contractors are not held to the requirements of FAR Part 31 when negotiating firm-fixed-price contracts where price analysis is used to determine fair and reasonable pricing. In fact this is explicitly stated at FAR 15.404-1(b)(1): “Price analysis is the process of examining and evaluating a proposed price without evaluating its separate cost elements and proposed profit.” Per the Definitions at FAR 2.101, Pricing means the “process of establishing a reasonable amount or amounts to be paid for supplies or services.” In these cases, there is no proposed cost and fee, only a proposed price. In turn, we must examine situations where cost analysis is utilized.

Within FAR 31.1, Applicability, Section 31.102 Fixed-price contracts introduces the only circumstances in which FAR Part 31 Cost Principles will have a bearing on fixed-price contracts, pre- or post-award. Specifically, FAR 31.102 states:

“The applicable subparts of part 31 **shall be used in the pricing** of fixed-price contracts, subcontracts, and modifications to contracts and subcontracts whenever (a) cost analysis is performed, or (b) a fixed-price contract clause requires the determination or negotiation of costs. **However, application of Cost Principles to fixed-price contracts and subcontracts shall not be construed as a requirement to negotiate agreements on individual elements of cost in arriving at agreement on the total price. The final price accepted by the parties reflects agreement only on the total price (emphasis added).** Further, notwithstanding the mandatory use of Cost Principles, the objective will continue to be to negotiate prices that are fair and reasonable, cost and other factors considered.”

Therefore, there are certain instances where a firm-fixed-price proposal is reviewed by the government in conjunction with applicable parts of FAR Part 31, but only for purposes of analyzing a total proposed price. This applies whenever cost analysis is performed, and that is largely left up to the discretion of the contracting officer when determining price reasonableness, except where certified cost or pricing data is required. Regardless, such a review is only for purposes of determining the reasonableness of the total proposed price, as agreement of the final price remains ultimately a matter of price negotiation. As such, cost analysis of this nature is only to inform negotiations in situations like sole source procurements where contracting officers are required to do cost analysis to help determine reasonableness in combination with price analysis techniques.

# How to Establish Your Negotiation Position

Many organizations that operate with a diverse government contracting portfolio establish a compliance infrastructure that will ensure unallowable costs are excluded from any bill, claim, or proposal to the government where required. However, that does not restrict a contractor's ultimate latitude in price negotiations. In the case of fixed-price negotiations subject to certified cost or pricing data, or where cost analysis is performed, the identification and presentation of unallowable cost in accordance with FAR Part 31 is an important element to maintaining compliance, but it also provides the opportunity to demonstrate real costs incurred in the negotiation of a total reasonable price, inclusive of all cost factors considered.

In our experience, some contracting officers (and prime contractors, when negotiating with subcontractors) will resort to negotiating individual cost elements based on FAR Part 31 when identified through cost analysis. Indeed, this can be difficult to avoid once such costs are properly disclosed and/or where the contracting officer is used to cost-reimbursement contracts. Yet, the point is that the ultimate outcome and objective is only a negotiation on price. As such, contractors should be wary of this approach if it ultimately leads to negotiating specific elements of cost. The difference is subtle but important as the regulations do not actually restrict the ability for the contracting officer (or prime contractor) to arrive at a fair and reasonable price. After a fixed-price negotiation position has been informed by cost analysis, negotiators should then focus discussions on the end price. In navigating these discussions, contractors may consider the following points:

- ▶ The approach of "disallowing" proposed cost not expressly unallowable per FAR 31 is not supported by regulation and misconstrues the ultimate intent of negotiating fixed-priced contracts.
- ▶ The goal is to ultimately negotiate a fair and reasonable price, not individual elements of cost.
- ▶ It is important to continue to disclose information consistent with FAR Part 31 and CAS 405, Accounting for Unallowable Costs, as it pertains to the fixed-price amounts proposed yet also helpful to acknowledge the total costs incurred inclusive of costs classified as unallowable.
- ▶ The courts and administrative boards have repeatedly held that there need not be any relationship between a contractor's price and any cost or pricing data submitted (e.g., *Info. Sys. & Networks Corp. v. United States*, 64 Fed. Cl. 599, 607 (2005)).

- ▶ Consistent with FAR 31.102, the objective in these circumstances will continue to be to negotiate prices that are fair and reasonable, cost, and other factors considered.

In addition to the above, Chapter 43 – Allowable Costs of United States Code, Title 41, which covers federal procurement policy, may offer more help during negotiations. Sec. 4301 – Definitions at 41 USC 4301(2) defines a “covered contract” for purposes of applicability of cost allowability as: “...a contract for an amount in excess of \$500,000 that is entered into by an executive agency, except that the term does not include a fixed-price contract without cost incentives or any firm-fixed-price contract for the purchase of commercial products or commercial services.”

## Proposed vs. Actual Cost Requirements

It is important to remember that the above guidance relates to proposed cost, not actual costs. As described above, in the proposal phase, the FAR Cost Principles’ role is limited to fixed-price contracts only where cost analysis is performed, and then only to inform a negotiation on price. However, for these contracts post-award, when actual costs are incurred, the Cost Principles are almost entirely inapplicable (absent, for example, undefinitized awards, progress payments, or certain incentive payments) because the price has already been negotiated and agreed to.

A fixed-price contract “places upon the contractor maximum risk and full responsibility for all costs and resulting profit or loss. It provides maximum incentive for the contractor to control costs and perform effectively and imposes a minimum administrative burden upon the contracting parties.” (FAR 16.202-1.) For that reason, firm-fixed-price contracts do not include the Allowable Cost and Payment clause at FAR 52.216-7 which applies when a cost-reimbursement contract or a time-and-materials contract (other than a contract for a commercial product or commercial service) is contemplated and serves to apply the FAR Cost Principles post-award. Further to this point and for the very same reasons, the DCAA Directory of Audit Programs, Planning Considerations states: “When the contract instrument is fixed-price with no downward adjustment clause, the government derives no benefit from either prime or subcontractor audits performed after negotiation of the prime contract. If the auditor becomes aware that a requested pre-award audit pertains to a fixed-price contract already negotiated by a DoD or non-DoD agency, the auditor should advise the requester that an audit is inappropriate unless a recapture clause has been included in the

contract.”

## The Bottom Line on the FAR Cost Principles

The FAR Cost Principles apply to fixed-price negotiated contracts only in specific circumstances pre- and post-award. It is these nuances in the regulation that can lead to their potential misapplication, confusion, and/or additional outside inquiry, especially in the proposal phase of the contract lifecycle.

For contractors, transparency of costs is necessary in specific fixed-price negotiations, particularly sole source situations where cost analysis is utilized. However, in those circumstances, the negotiating objectives should not be individual elements of cost but rather price. In other words, the end result remains a negotiation between the parties. This will necessarily vary in the circumstances and take into account the “other factors” referenced in FAR 31.102. While FAR 31 is a factor in such a context, it is not determinative of the end price or the ultimate business objectives of either party. As a practical matter, one of the government’s objectives is to ensure a healthy, stable, and profitable defense supply base, and unallowable costs, whether negotiated or not, remain true costs to each contractor and affect their ability to earn a reasonable profit.

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