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¶ 1 Public Works Construction Contractors And The FAR

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Companies that regularly do business with the Federal Government under cost-reimbursement contracts are subject to complex cost accounting rules stipulated in the Federal Acquisition Regulation, agency supplements to the FAR and other requirements (e.g., the Cost Accounting Standards). As such, these companies have designed their accounting systems and tailored their processes to help ensure compliance with the litany of cost accounting rules, compliance requirements and audits from their Government customers.

However, construction contractors and subcontractors are often engaged on public works projects with state and local agencies, and can end up subject to many of the same FAR cost accounting requirements. These state and local projects may include federal funding that references FAR rules directly, or the state and local agencies may include contract clauses mirroring requirements of the FAR.

This two-part article discusses these issues. Part One provides background information on the relevant FAR provisions that construction contractors may encounter, discusses how these provisions get incorporated into construction contracts, identifies some issues that arise for construction contractors, and suggests some best practices for construction contractors. Part Two, to be published in the spring, will discuss specific guidelines on preparing price adjustment proposals and claims, and illustrate specific recommendations and common pitfalls for proposals and claims for delays and disruptions.

The FAR and Construction Contracts

FAR pt. 36, Construction and Architect-Engineer Contracts, prescribes how the Government will procure construction contracts. It identifies a preference for competitively bid (the FAR uses the term ''adequate price competition'') firm, fixed-price contracts for construction projects, but also discusses when and how construction projects can be procured on a negotiated basis.

Until 1996, the Federal Government was precluded from engaging in design-build contracts. This changed with the passage of the Clinger-Cohen Act,[2] which enabled agencies to consider design-build as an option, and described a two-step process to procure construction projects on this basis.

Regardless of the project delivery method employed, the FAR's cost accounting requirements are located in

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FAR pt. 31, Contract Cost Principles and Procedures, which contains cost principles and procedures for the determination of costs that the Government with reimburse.

FAR subpt. 31.105, Construction and architect-engineer contracts, identifies how and when the FAR applies to construction contracts, including,

> (1) Determining reimbursable costs under cost-reimbursement contracts, including cost-reimbursement subcontracts thereunder;
>
> (2) Negotiating indirect cost rates;
>
> (3) Proposing, negotiating or determining costs under terminated contracts;
>
> (4) Price revision of fixed-price incentive contracts; and
>
> (5) Pricing changes and other contract modifications.[3]

This article focuses on construction contracts that have been awarded by a state or local agency on a competitively bid, fixed-price basis. Such a contract would at first be exempt from these rules under item (1) above. However, in the case of a negotiated change to that fixed-price contract, whether under the changes clause,[4] as a request for equitable adjustment, or in the case of a dispute, that change would be subject to the FAR rules under items (2), (4) and (5) above. A contractor would also be subject to the rules under item (3) above in the case of a contract that is terminated.

Once subject to these rules, FAR subpt. 31.2, Contracts with Commercial Organizations, is the main source of guidance regarding costs that the Government will reimburse. This guidance starts with FAR subpt. 31.201-1, which states that ''the *allowable* costs to government are limited to those *allocable* costs which are *allowable* pursuant to Part 31.''

Immediately after this section, FAR subpt. 31.201-2, Determining allowability, introduces the word ''allowability'' into the lexicon. This clause reads, in part,

> 31.201-2 Determining allowability.
>
> (a) A cost is allowable only when the cost complies with all of the following requirements:
>
> (1) Reasonableness.
>
> (2) Allocability.
>
> (3) Standards promulgated by the CAS Board, if applicable, otherwise, generally accepted accounting principles and practices appropriate to the circumstances.
>
> (4) Terms of the contract.
>
> (5) Any limitations set forth in this subpart.

From this fairly simple introduction flows a complex set of rules and regulations for what costs can be reimbursed and how they should be documented. The same FAR section, FAR subpt. 31.201-2(d) also places the onus squarely on the contractor to comply with these rules:

> A contractor is responsible for accounting for costs appropriately and for maintaining records, including supporting documentation, adequate to demonstrate that costs claimed have been incurred, are allocable to the contract, and comply with applicable cost principles in this subpart and agency supplements. *The contracting officer may disallow all or part of a claimed cost that is inadequately supported.* [Emphasis added.]

Construction contractors that have not implemented processes and systems to accumulate detailed cost data at the contract level will likely have difficulty compiling the detailed accounting data that is required to support an REA or claim, or to otherwise prove up costs in a manner compliant with FAR pt. 31. This could lead to serious problems with the adequacy of the contractor's submission (e.g., an REA) and may create exposure under federal, state or local false claims acts (discussed later in this article).

Unique Construction Cost Issues

FAR subpt. 31.105 recognizes several unique cost aspects involved in construction projects. It suggests that the CO should consider advance agreements for home office overhead, partners' compensation and equipment usage.[5] In the typical public works construction contract, such advance agreements are not done, but the mention of these types of agreements in this section of the FAR indicates that they can be (and have been) cause for dispute.

For example, home office overhead (or general and administrative (G&A) cost) is often in dispute in pricing changes. A typical construction contractor has prepared a bid estimate that includes an estimate of his

direct costs and adds a ''markup,'' or fee or profit. This markup on all of the projects underway by a contractor is intended to cover both the costs of running the contractor's organization and, if the volume is sufficient, leave the contractor with a net profit by the end of the year. In pricing changes, most contracts provide an agreed markup. Often the contract is not clear as to what this markup is intended to cover. The contractor may argue that this contractual markup is insufficient to recover both home office overhead and a fair profit or fee. The contractor will attempt to add a factor for home office overhead to its change proposal before adding the markup. This home office factor is often disputed and not supported by the types of detailed contract cost accounting records that governmental auditors prefer.

Construction equipment, typically owned by contractors, also is a special area of consideration under this section of the FAR. Cost issues can arises because construction contractors often own significant amounts of heavy construction equipment that is deployed to projects. In order to manage and account for that equipment on projects, contractors develop internal equipment rates to charge the equipment to the project based on the time the equipment was on site, the hours the equipment was actually used, or some combination of the two.

The Government may challenge these internal equipment rates on the basis that they may not reflect the contractor's cost for that equipment, as cost is defined in FAR pt. 31. The FAR dictates a preference for the ''actual cost data'' related to that equipment. However, recognizing that this actual cost data are not easily available for specific pieces of equipment, the FAR provides that various equipment rate guides, published by the Army Corps of Engineers or commercial entities, may be used.[6] Typically, such rate guides are included in the changes clause within the contract. Even when certain rate guides are contractually specified, disputes often occur as to the application of the specified rates, including the measurement of operating versus idle equipment, the specific factor to be used, treatment for equipment for which there is no specified rate, and other issues.

On the plus side for contractors, FAR subpt. 31.105 recognizes that contractors deploy significant resources to a jobsite to manage the construction process. This ''jobsite overhead,'' including rented land or facilities, is specifically identified as an allowable indirect cost of the project, as long as it is consistently accounted for and applied to the cost objectives. Depending on the terms of the contract, in pricing a change, a contractor could consider including this indirect cost prior to the contractual markup (i.e., profit or fee).

Examples of FAR Provisions in State and Local Contracts

In many cases, public works projects may include federal funding, which requires specific FAR provisions to be incorporated into a contract. For example, a state utility's request for technical and price proposals stated, ''[t]his Contract will be funded in part by a grant from the United States Environmental Protection Agency and will be subject to all regulations contained in [FAR pt.] 31.''[7]

FAR provisions (or provisions very similar to the FAR) are also incorporated into many state agency contracts, even those without federal funding. For example:

- Many state departments of transportation prescribe the use of the American Association of State Highway and Transportation Officials (AASHTO) *Uniform Audit and Accounting Guide* when auditing contract costs.[8] The *Guide* stipulates requirements for a compliant accounting system and construction of compliant indirect cost rates. AASHTO guidance specifically states that ''[s]tate departments of transportation (DOTs) often rely on FAR pt. 31 for guidance when negotiating costs and reviewing project proposals with engineering consultants.''[9]

- Certain states require that prime contractors and subcontractors certify that all proposed indirect costs are allowable in accordance with FAR cost principals. For example, Vermont's indirect cost certification form requires the contractor to agree that ''[a]ll costs included in the indirect cost rates are allowable in accordance with the cost princi-

pals of the Federal Acquisition Regulation of title 28, Code of Federal Regulations (CFR), part 31'' and ''the indirect cost rate does not include any costs which are expressly unallowable under the Cost principals of the FAR of 24 CFR 31.''[10]

- As another example, a design-build contract between a large metropolitan transportation authority and a construction company references FAR pt. 31 as an applicable principle used during the audit process, indicating the ''Design Builder, its Subcontractors, Suppliers, and Design Builder-Related Entity are responsible for accounting for unallowable costs in accordance with FAR Subpart 31.201-6. All costs that are expressly unallowable or mutually agreed to be unallowable, including directly associated costs, shall be excluded from any billing, claim, or proposal applicable to this Contract.''[11]

Subcontractors are generally not exempt from FAR requirements. Prime contractors will usually flow down FAR provisions into their subcontracts. Even absent such flow-down provisions, subcontractors are likely to find that their prime contractors will request cost data that would be substantially the same as if the FAR provisions were actually flowed down to the subcontract.

So What Are the Rules?

As stated above, FAR subpt. 31.201-2 identifies what constitutes an allowable cost. For a construction contractor pursuing a change to a fixed-price contract, allowability boils down to ''allocability,'' ''reasonableness'' and ''any limitations set forth in this subpart.''

Allocability

FAR subpt. 31.201-4 lists criteria relating to costs being allocated to Government contracts. Specifically, a cost is *directly* allocable to a Government contract if it is incurred specifically for a contract (i.e., a direct cost); it benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received (i.e., an ''overhead'' cost); or the cost is necessary to the overall operation of the business, even though a direct relationship to any particular cost objective cannot be shown (typically identified as a G&A expense, which is classified as an indirect cost).[12]

The classification, accumulation and allocation of direct and indirect costs are usually defined by a contractor's cost accounting practices. The Government generally recognizes that different businesses have different methods of accounting for indirect costs. The typical challenge faced by contractors centers around the consistency with which they apply cost accounting practices. For example, on a large project, a project manager may be charged directly to the project. However, project managers on other projects may be charged to indirect expenses in certain circumstances. If a change proposal includes both the direct-charged project manager and allocations for all other project managers, the Government would likely challenge the costs on the basis of allocability due to the inconsistent practice.

Reasonableness

Reasonableness is the least objective standard in FAR subpt. 31.201. FAR subpt. 31.201-3 does not provide a concrete set of facts and circumstances under which a cost is reasonable, but instead defines a cost as reasonable if it ''does not exceed that which would be incurred by a prudent person in the conduct of competitive business.''[13]

Prior to 1987, the FAR was silent on the burden of proof of reasonableness. Up to that time, absent a contract provision to the contrary, the courts had inferred a presumption of reasonableness of a cost incurred by a contractor, shifting the burden to the Government to prove a cost was not reasonable. In 1987 this FAR section was revised to read:

> *No presumption of reasonableness shall be attached to the incurrence of costs* by a contractor. If an initial review of the facts results in a challenge of a specific cost by the contracting officer or the contracting officer's representative, *the burden of proof shall be upon the contractor to establish that such cost is reasonable*. [Emphasis added.]

This standard is now a major weapon available to the Government in negotiating a change proposal. Al-

legations by the Government that a change proposal is not reasonable can be based on a variety of reasons, including inadequate documentation, failure to provide the appropriate credit for work not performed, duplicate cost recovery. It is therefore crucial that contractors maintain adequate books and records, and carefully support change proposals based on those records to support the reasonableness of costs incurred.

Any Limitations Set Forth in this Subpart

The most significant limitations that arise are found in FAR subpt. 31.205, Selected costs, which contains the stipulated cost treatment for several selected items of cost. This section contains over 50 subsections that deal with cost types. Many of the sections describe costs that are generally allowable and their calculation (e.g., compensation for personal services, depreciation and insurance). However, there are a number of costs that are expressly not allowed for reimbursement, including,

- 31.205-1—Public relations and advertising costs (limited exceptions);
- 31.205-3—Bad debts;
- 31.205-7—Contingencies (some exceptions);
- 31.205-8—Contributions or donations;
- 31.205-14—Entertainment costs;
- 31.205-15—Fines, penalties, and mischarging costs;
- 31.205-20—Interest and other financial costs;
- 31.205-22—Lobbying and political activity costs;
- 31.205-23—Losses on other contracts; and
- 31.205-51—Costs of alcoholic beverages.

Besides excluding any such unallowable costs, FAR subpt. 31.201-6, Accounting for unallowable costs, requires that ''directly associated'' costs[14] also be excluded. A directly associated cost is ''any cost which is generated solely as the result of the incurrence of another cost, and which would not have been incurred had the other cost not been incurred.''[15]

For construction contractors, a few of these unallowable costs may be included in the jobsite overhead category. However, such costs most often arise in the pool of G&A costs. Unallowable costs that find their way into a change proposal are often minor, but can have wide-ranging consequences (e.g., allegations of false claims).

Many contractors deal with this issue by including as part of their annual audit a schedule that computes FAR-compliant indirect cost rates. This is often included as a supplementary schedule to the contractor's annual financial statements, or may be a stand-alone report with a separate opinion from the auditor.

Conclusion

An understanding of the FAR is critical for construction contractors, and not just those who do business with the Federal Government. A construction contractor or subcontractor working on state or local projects also needs to understand these requirements. Noncompliance can have severe consequences in the resolution of change proposals. Serious noncompliance can even result in allegations of federal, state or local false claims act violations.[16] In Part Two of this article, we will further discuss specific guidelines on preparing price adjustment proposals and claims. We will also illustrate specific recommendations and common pitfalls for price adjustment proposals and claims for delays and disruptions.

ENDNOTES:

[2]Clinger-Cohen Act of 1996, Pub. L. No. 104-106, § 4001 (41 U.S.C.A. § 253m).

[3]See FAR 31.105(c).

[4]See, for example, FAR 52.243-1, Changes—Fixed Price Contracts.

[5]See FAR 31.105(d)1.

[6]See FAR 31.105(d)2. This section provides that these rate guides should be ''predetermined,'' in other words, specified in the contract. Although they often are specified, disputes may occur over how the specific guide should be applied, how the operating and idle hours should be measured, and other issues.

[7]State water procurement contract. [Date redacted.] [Parties redacted.]

[8]Examples of states which reference the *Guide* for the auditing of costs of certain contracts include Arizona, California, Connecticut, Florida, Minnesota, South Carolina, Texas and Virginia.

[9]American Association of State Highway and

Transportation Officials, *Uniform Audit and Accounting Guide*, Chapter 4.

[10]Vermont Agency of Transportation, *Indirect Cost Certification Form*.

[11]Metropolitan design build contract. [Date redacted.] [Parties redacted.]

[12]FAR subpt. 31.201-4. 1.

[13]Specifically, FAR subpt. 31.201-3(b) lists the following considerations and circumstances: ''(1) Whether [a cost] is the type of cost generally recognized as ordinary and necessary for the conduct of the contractor's business or the contract performance; (2) Generally accepted sound business practices, arm's-length bargaining, and Federal and State laws and regulations; (3) The contractor's responsibilities to the Government, other customers, the owners of the business, employees, and the public at large; and (4) Any significant deviations from the contractor's established practices.''

[14]FAR subpt. 31.201-6(a).

[15]FAR subpt. 31.001.

[16]All 50 states (and Washington, D.C.) have false claims or fraud statutes that may be cited in the case of noncompliance with FAR requirements in federally funded contracts, and many of these jurisdictions include civil and/or criminal penalties in their statues.