

Managing Cost Reimbursable Contracts

Providing Guidance in Difficult Waters Management Guide & Desk Reference

Compiled and Written by:

Don Philpott

Scott P Cook

233 Pages

ISBN: 978-0-9844038-6-8

Published by Government Training Inc.

Sample Table of Contents and Opening Chapter

Tale of Contents

Cost-reimbursement contracts.....	4
1. What is a cost-reimbursement contract?.....	4
Unique type of contract.....	8
2. Background/history	12
History of government contracts in general.....	12
The birth of CR in WWI and WWII	12
The two acts in 1947 and 1949	12
More recently	12
FAR and cost-reimbursement contracts.....	12
3. Types of cost-reimbursement contracts.....	29
Application of predetermined, formula-type incentives.....	36
Cost incentives	36
Performance incentives	12
Delivery incentives.....	12
Structuring multiple-incentive contracts.....	12
Cost-plus-incentive-fee contracts.....	12
Cost-plus-award-fee contracts.....	12
Advantages of cost-plus pricing.....	12

Disadvantages of cost-plus pricing	39
4. What are the uses of CR?	12
Reasons for using – according to federal departments.....	12
Funding doubts	12
Conditions for use.....	12
Surveillance	12
Approvals required	12
Statement of work issues.....	12
How can I contract for something that doesn't exist?	12
Why bother to write a statement of work for something that we can't define?	50
Use of performance-based contracting in CR.....	51
5. What are the dangers?	12
Schedule slips.....	12
Overruns.....	12
FAR 32.704: Limitation of cost or funds.	52
Lack of government control.....	12
6. What are the dangers in not using them?	12
Some famous and infamous contracting disasters.....	12
7. Current state/statutory guidelines	60
Limitation of cost (LOC)/Limitation of funds (LOF).....	60
Cost analysis.....	12
Negotiation of fee/weighted guidelines	12
8. Allowable costs	12
31.201-2 <i>Determining allowability.</i>	12
31.205-1 <i>Public relations and advertising costs.</i>	12
31.205-3 <i>Bad debts.</i>	76
31.205-4 <i>Bonding costs.</i>	12
31.205-6 <i>Compensation for personal services.</i>	12
31.205-7 <i>Contingencies.</i>	12
31.205-8 <i>Contributions or donations.</i>	89
31.205-10 <i>Cost of money.</i>	89
31.205-11 <i>Depreciation.</i>	12
31.205-12 <i>Economic planning costs.</i>	12
31.205-13 <i>Employee morale, health, welfare, food service, and dormitory costs and credits.</i>	12
31.205-14 <i>Entertainment costs.</i>	93
31.205-15 <i>Fines, penalties, and mischarging costs.</i>	93
31.205-16 <i>Gains and losses on disposition or impairment of depreciable property or other capital assets.</i>	12
31.205-17 <i>Idle facilities and idle capacity costs.</i>	95
31.205-18 <i>Independent research and development, and bid and proposal costs.</i> ..	96
31.205-19 <i>Insurance and indemnification.</i>	12
31.205-20 <i>Interest and other financial costs.</i>	12
31.205-21 <i>Labor relations costs.</i>	101

31.205-22 Lobbying and political activity costs.	101
31.205-23 Losses on other contracts.	12
31.205-25 Manufacturing and production engineering costs.	12
31.205-26 Material costs.	12
31.205-27 Organization costs.	12
31.205-28 Other business expenses.	12
31.205-29 Plant protection costs.	105
31.205-30 Patent costs.	12
31.205-31 Plant reconversion costs.	12
31.205-32 Precontract costs.	12
31.205-33 Professional and consultant service costs.	106
31.205-34 Recruitment costs.	12
31.205-35 Relocation costs.	108
31.205-36 Rental costs.	12
31.205-37 Royalties and other costs for use of patents.	12
31.205-38 Selling costs.	12
31.205-39 Service and warranty costs.	113
31.205-40 Special tooling and special test equipment costs.	12
31.205-41 Taxes.	12
31.205-42 Termination costs.	12
31.205-43 Trade, business, technical and professional activity costs.	12
31.205-44 Training and education costs.	12
31.205-46 Travel costs.	12
31.205-47 Costs related to legal and other proceedings.	122
31.205-48 Research and development costs.	125
31.205-49 Goodwill.	125
31.205-51 Costs of alcoholic beverages.	12
31.205-52 Asset valuations resulting from business combinations.	12
Allocability.	12
31.201-4 Determining allocability.	12
9. Contract administration.	126
Overruns.	133
Changes.	12
Identify the need to change the contract.	12
Prepare a technical analysis.	12
Delays.	12
Defects.	12
Termination.	148
Terminations—noncommercial items (FAR Part 49).	148
Terminations—commercial items.	149
Circumstances leading to termination.	149
Subcontracts (FAR 53.244-2).	12
Disputes.	156
10. Views and discussion of CR.	165

GAO	165
Audits	12
11. Resources	12
Attachment 1, Civilian Board of Contract Appeals -- Rules of Procedure.....	176
Attachment 2, Application of federal statutes.....	215
Attachment 3, Pricing termination settlements.....	220

1. What is a cost-reimbursement contract?

A **cost-reimbursement contract** is a contract where a contractor is paid for all of its allowed expenses to a set limit, plus additional payment to allow for a profit. Cost-reimbursement contracts contrast with a fixed-price contract, in which the contractor is paid a negotiated amount regardless of incurred expenses.

Federal agencies can choose among three main contract types to procure goods and services: fixed-price, time-and-materials, and cost-reimbursement. Each contract type comes with a different level of cost or performance risk for the government. Different types of cost-reimbursement contracts can be used based on whether incentives, award fees, or other arrangements are offered to motivate contractor efforts and discourage contractor inefficiency and waste.

Government	Contractor	Risk to ...
<p>Fixed-price Pays fixed price even if actual total cost of product or service falls short of or exceeds the contract price. May also pay an award or incentive fee related to performance.</p>	<p>Provides an acceptable deliverable at the time, place, and price specified in the contract.</p>	<p>Contractor</p>
<p>Time-and-materials Pays fixed per-hour labor rates that include wages, overhead, general administrative costs, and profit; government might reimburse contractor for other direct costs, such as travel and materials costs. Contracts include a ceiling price that the contractor exceeds at its own risk. Government is not guaranteed a completed end item or service within the</p>	<p>Makes good faith effort to meet government's needs within the ceiling price.</p>	<p>Government</p>

ceiling price.		
<p>Cost-reimbursement Pays contractor’s allowable costs incurred, to the extent prescribed by the contract. Also may pay a fee, which may be related to performance. Contracts include an estimated total cost for purposes of obligating funds and a ceiling that the contractor exceeds at its own risk (unless approved by the contracting officer). Government is not guaranteed a completed end item or service within the estimated cost. The FAR prohibits the use of cost-reimbursement contracts to acquire commercial items.</p>	Makes good faith effort to meet government’s needs within the estimated cost.	Government

The cost-reimbursement contract is considered high risk for the government because of the potential for cost escalation and because the government pays a contractor’s costs of performance regardless of whether the work is completed. As such, cost-reimbursement contracts are suitable only when the cost of the work to be done cannot be estimated with sufficient accuracy to use any type of fixed-price contract.

The two major reasons for the inability to accurately estimate costs are (1) the lack of knowledge of the work needed to meet the requirements of the contract, for example, under research contracts, which necessarily involve substantial uncertainties, and (2) the lack of cost experience in performing work, such as the development of a weapons system where manufacturing techniques and specifications are not stable enough to warrant contracting on a fixed-price basis. When these conditions exist, the use of a cost-reimbursement contract may be appropriate. Conversely, when uncertainties have been reduced to a manageable level, a fixed-price contract generally is used. However, key controls to ensure the appropriate use of cost-reimbursement contracts are not always used by agencies when selecting this contract type.

In a GAO report on Department of Defense Acquisitions, it noted: “As we look across DOD’s many weapons programs, we typically see a migration from cost-type to fixed-price contracts as programs move from development to production. We become concerned, however, when we see programs like the Joint Strike Fighter move into the production phase for significant quantities under a cost-reimbursement contract, which suggests that the program still faces significant uncertainties and cost risks. The choice of contract type in this case may be consistent with the level of risk the program faces, but that level of risk may indicate a program not yet ready for production.

“A variety of other contract types or agreements are also available, such as indefinite delivery/ indefinite quantity contracts, blanket purchase agreements, and undefinitized

contract actions. While these contracts and agreements offer the government the ability to adapt its business arrangements to the situation at hand, when they are not used properly the government could be exposed to undue risk. For example, we reported that agencies are not maximizing opportunities for competition or savings under blanket purchase agreements. Similarly, with the use of undefinitized contract actions, we have reported that the contractor has little incentive to control costs, creating a potential for wasted taxpayer dollars.

“Regardless of the contract type selected, competition is the cornerstone of the acquisition process, and the benefits of competition in acquiring goods and services from the private sector are well established. Promoting competition – as opposed to sole-source contracts, where the government negotiates with only one source – can help save the taxpayer money, improve contractor performance, and promote accountability for results. Agencies are required to perform acquisition planning and conduct market research for all acquisitions in order to promote and provide for, among other things, full and open competition. There are certain circumstances when sole source contracts may be appropriate, such as urgent needs or when there is truly only one source to provide the good or service, and Congress has allowed for such flexibility. However, our work has identified situations where the government has not taken advantage of opportunities to compete work. For example, we found that the Army had issued contracts for security guards at U.S. military installations on a sole-source basis. Based on our recommendations, the contracts subsequently were competed, which resulted in cost savings.”

To mitigate risk and help ensure that the best interests of the government are served when entering into a cost-reimbursement contract, agencies may use this contract type only if the contractor’s accounting system is adequate for determining costs applicable to the contract. This helps prevent situations where contractors bill the government for unallowable costs. Appropriate government surveillance is also required to provide reasonable assurance that the contractor is using efficient methods and effective cost controls.

Cost-reimbursement contracts

There are several variations of cost-reimbursement contracts, the most common being cost-plus-fixed-fee. This type of contract is used when uncertainties in contract performance are of such magnitude that the cost of performance cannot be estimated with sufficient reasonableness to permit use of a fixed-price contract. Rather than guaranteeing to perform under a contract at a specified price, the contractor agrees to deliver its "best efforts" to perform the requirements in return for costs incurred and a reasonable fee. This type of contract requires negotiation of estimated cost and payment of a fixed dollar fee to the contractor. The fee cannot be changed unless the government changes the scope of work in the contract.

Because the contractor cannot specify the exact price of performing, a “total estimated cost” is agreed. This total estimated cost represents the best estimate of both the government and the contractor, agreed to in negotiations. It also is a contract cost limitation that the contractor cannot exceed, except at the risk of non-reimbursement. This limit can be changed by mutual agreement of the government and the contractor through a modification to the contract.

The contracting officer is prohibited from negotiating a fee that exceeds 15 percent of the contract’s estimated cost, excluding fee, for research and development contracts. This holds for architect/engineer contracts also, where the limit is six percent. For other cost-plus-fixed-fee contracts, the fee limitation is 10 percent of the contract’s estimated cost, excluding fee.

Every fully funded cost-reimbursement-type contract must contain the **Limitation of Cost** clause. It limits the government’s liability if the contractor exceeds the total estimated cost. The clause requires the contractor to notify the government when it expects to reach 75 percent of the total estimated costs in the next 60 days.

For those cost-reimbursement-type contracts that are incrementally funded, insert the **Limitation of Funds** clause. This clause identifies the present amount available for payment by the government, the money allotted to this contract, items covered – and the government’s share of the cost if this is a cost-sharing contract – and the period of performance the estimated amount allotted will cover.

Contracting officers, contracting officer technical representatives (COTRs) and the contractors should review both clauses carefully. They spell out the essential nature of cost-reimbursement contracts in terms of contractor performance obligations and cost/fund limitations. The Limitation of Cost clause can be found at FAR 52.232-20. The Limitation of Funds clause can be found at FAR 52.232-22. In cost-plus-fixed-fee contracts, the contractor’s risk is minimal. The contractor only promises to do its best (or “use its best effort”) to perform the work. No guarantee is given to the government. Failure to do the specified work will not be a breach of contract, nor will it cost the contractor any money, as long as it used its best efforts.

The government’s risk is commensurately high. It has no guarantee that it will get the specified work. If the work is not completed and the maximum costs have been reimbursed to the contractor, the government has two choices, equally unsatisfactory. It can elect (1) not to add funds to the contract and therefore not get any further work, or (2) to add money to the contract to fund the remaining work. This latter action is known as funding the cost overrun.

Cost overruns are an unavoidable risk of the cost-reimbursement-type contract. While overruns are occasionally caused by contractor waste or inefficiency, far more often

they are due to the unavoidable lack of certainty in contract requirements. Given the nature of the work acquired by cost-reimbursement contracts, contractor performance often evolves in ways neither the contractor nor the government foresaw at the time of award. Because of the high government risk and the lack of guaranteed performance, cost-reimbursement contracts must be monitored far more closely than fixed-price types. The project officer must ensure that the contractor is indeed providing its best efforts and that the contractor is judiciously expending funds and controlling cost. In addition to the cost-plus-fixed-fee contract, there are several other kinds of cost-reimbursement-type contracts.

COST-REIMBURSEMENT CONTRACTS
<ul style="list-style-type: none">• Cost-sharing (CS)• Cost-plus-incentive-fee (CPIF)• Cost-plus-award-fee (CPAF)• Cost-plus-fixed-fee (CPFF)

Other variations of cost-reimbursement contracts include:

- Cost-plus-award-fee that provides for a base fee, fixed at inception of the contract, and an additional award fee amount the contractor may earn with exceptional performance.
- A cost contract with no fee.

In cost-reimbursement contracts, contractor risk is minimal and government risk is high. The government has no guarantee it will get the specified product or service. If the product or service is not complete and the maximum cost has been reimbursed to the contractor, the government has equally unsatisfactory choices. It can elect to not add funds to the contract and get no further work or it can add money to fund the remaining work.

Given the nature of the work acquired by cost-reimbursement contracts, contractor performance often evolves in ways neither the contractor nor government foresees at the time of award. As already stated, because of high government risk and lack of guaranteed performance, cost-reimbursement contracts must be monitored far more closely than fixed-price. The COTR and contracting officer must ensure the contractor is providing its best efforts, and is efficiently expending funds and controlling costs.

Unique type of contract

Cost-reimbursement contracts are suitable only when uncertainties involved in contract performance do not permit costs to be estimated with sufficient accuracy to use a fixed-price contract. The two major reasons for the inability to accurately estimate costs are (1) the lack of knowledge of the work needed to meet the requirements of the contract,

for example, under research contracts, which necessarily involve substantial uncertainties, and (2) the lack of cost experience in performing work, such as the development of a weapons system because manufacturing techniques and specifications are not stable enough to warrant contracting on a fixed-price basis. We have reported that during weapons system development, the Department of Defense (DOD) often asks prime contractors to develop cutting-edge systems and awards cost-reimbursement contracts for the work. Because the government often does not perform the up-front analysis needed to determine whether its needs can be met by the contract requirements, significant cost increases can occur under the contracts as the scope of requirements changes or becomes better understood. As of fiscal year 2007, for example, DOD anticipated reimbursing the prime contractors on the Joint Strike Fighter and Future Combat Systems programs nearly \$13 billion more than initially expected.

Cost-reimbursement contracts involve significantly more government oversight than do fixed-price contracts, which means the government incurs additional administrative costs on top of what it is paying the contractor. For example, the government must determine that the contractor's accounting system is adequate for determining costs related to the contract and update this determination periodically. In addition, contractor costs need to be monitored – known as cost surveillance – to provide reasonable assurance that efficient methods and effective cost controls are used.

Cost-reimbursement contracts are appropriate when contracting for requirements that involve substantial uncertainties, but they require careful management to protect the government's interests. At a macro level, careful management is enabled by good information. Current reporting in FPDS-NG, specifically regarding the combination contract type and billions of dollars with missing contract types, does not provide decision makers with adequate visibility into the government's use of cost-reimbursement contracts. Further, while the FAR cautions against the protracted use of cost-reimbursement contracts after experience provides a basis for firmer pricing, it does not set forth procedures or provide guidance for doing the analysis needed to make this determination. While recent congressional and executive branch actions are intended to help ensure that cost-reimbursement contracts are used only when appropriate, they have yet to take full effect.

A cost-reimbursement contract may be used only when:

- (1) The contractor's accounting system is adequate for determining costs applicable to the contract; and
- (2) Appropriate government surveillance during performance will be provided.

The use of cost-reimbursement contracts is prohibited for the acquisition of commercial items.

Advantages

- In contrast to a fixed-price contract, a cost-plus contractor has little incentive to cut corners.
- A cost-plus contract is often used when long-term quality is a much higher concern than cost, such as in the United States space program.
- Final cost may be less than a fixed price contract because contractors do not have to inflate the price to cover their risk.

Disadvantages

- There is limited certainty as to what the final cost will be.
- Requires additional oversight and administration to ensure that only permissible costs are paid and that the contractor is exercising adequate overall cost controls.
- Properly designing award or incentive fees also requires additional oversight and administration.
- There is less incentive to be efficient compared to a fixed-price contract.

How much cost-reimbursement contracting does the government do?

Federal agencies obligate more than \$100 billion annually using cost-reimbursement contracts, however, the complete picture of the government's use of cost-reimbursement contracts is unclear, according to a GAO report. From fiscal years 2003 through 2008, federal obligations under cost-reimbursement contracts were reported to have increased by \$16 billion, from \$120 billion to \$136 billion. When viewed as a percentage of total reported federal obligations, this represented a decrease over the six-year period, from 34 percent to 26 percent.

However, this decrease is misleading for several reasons, including a significant increase in agencies' reported obligations under the "combination" contract type, which includes cost-reimbursement obligations, and contradictory guidance in the FPDS-NG user manual, which could result in misreporting of contract type. Further, although contract type is a data-element field required in FPDS-NG for all awards, GAO found billions of dollars reported as missing a contract type (i.e., no specific contract type was indicated) or indicating "other" as the contract type

In fiscal year 2008, over \$10 billion in obligations was reported as missing a contract type and \$4.3 billion reported as "other." In addition, some very large contracts that had been previously labeled as cost-reimbursement were subsequently coded as missing a contract type. For example, six Navy contracts with missing contract types had been coded as in prior years as predominantly cost-reimbursement; in total these contracts accounted for over \$2 billion.

FPDS-NG guidance prohibited use of the “other” category as a contract type beginning in fiscal year 2009, but GAO found contracts in fiscal year 2009 with obligations of \$1.3 billion that were still using this category.

Ten Largest Procurement Categories Reported as Using Cost-Reimbursement Contracts in Fiscal Year 2008

Procurement	Obligations (in billions)	Percentage
Defense systems research and development	\$17.50	13
Professional services	14.80	11
Operation of government-owned buildings	14.50	11
Management support services	7.80	6
General healthcare services	7.10	5
Space research and development	6.50	5
Maintenance, repair, and rebuild of equipment	6.00	4
Automated data processing and telecommunications	5.80	4
Other research and development	5.70	4
Other	50.30	37
Total reported cost-reimbursement obligations	\$136.00	100

Source: GAO analysis of FPDS-NG data.

Note: These data do not include contract actions coded as “combination,” “other,” or “missing,” which could include cost-reimbursement obligations.

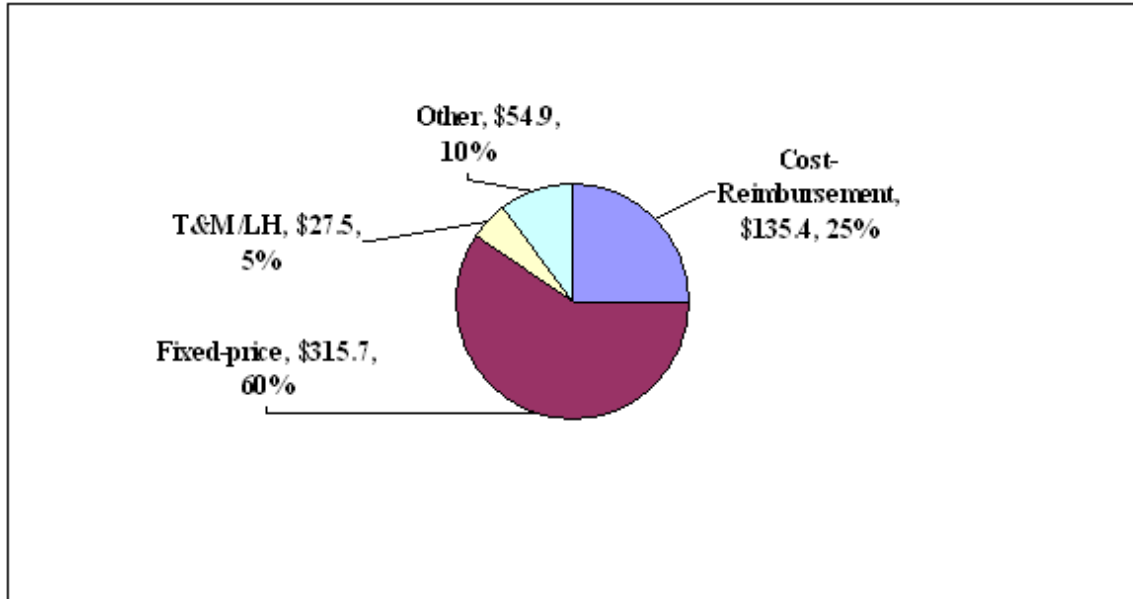
Data on Federal Agency Use of Cost-Reimbursement Contracting in FY 2008

Section 864(d) of the Duncan Hunter National Defense Authorization Act for Fiscal Year 2009, Public Law 110-417, requires the Office of Management and Budget (OMB) to report annually on the use of cost-reimbursement contracting by executive agencies. Specifically, the report is to include the following information for actions taken in the prior fiscal year:

- (1) The total number and value of contracts awarded and orders issued during the covered fiscal year; and
- (2) The total number and value of cost-reimbursement contracts awarded and orders issued during the covered fiscal year.

Government-wide snapshot

Figure 1: Obligations by Contract Type in FY 2008 (in \$ Billions)



Source: FPDS (February 2009)