

Amended FAR § 31.201-6 Permits Use of Statistical Sampling When Contractors Account for Unallowable Costs

Recent revisions to the FAR now expressly permit the use of “statistical sampling” by contractors when endeavoring to identify unallowable costs. After making substantive changes to the interim rule based upon public comments, the Civil Agency Acquisition Council (CAAC) and the Defense Acquisition Regulations Council (DARC) have agreed to a final rule revising FAR § 31.201-6 concerning accounting for unallowable costs. This rule will be effective October 31, 2005.

In short, the newly revised rule (1) permits a contractor to utilize statistical sampling to identify unallowable costs, subject to specific criteria for its use; and (2) advocates the use of advance agreements where a contractor decides to rely on statistical sampling. The amended rule does not alter the requirement that a contractor’s practices in accounting for unallowable costs must follow those described at CAS 405 (48 CFR 9904.405), but makes it clear that acceptable practices encompass statistical sampling and provides some general structure to the sampling process.

Sampling Criteria: First, the new rule expressly provides that statistical sampling is now “an acceptable practice” for use by a contractor in accounting for and presenting unallowable costs. The rule further provides that any statistical sampling must follow certain criteria which include:

- The statistical sampling results in an “unbiased sampling” that is a “reasonable representation of the sampling universe.” FAR § 31.201-6(c)(2)(i).
- “Any large dollar value or high risk transaction” must be “separately reviewed” and “excluded” from the sampling. FAR § 31.201-6(c)(2)(ii).
- The sampling permits “audit verification.” FAR § 31.201-6(c)(2)(iii).

The rule further makes it clear that, for any expressly unallowable indirect cost in the sample, the amount projected to the sampling universe from that sampled cost is subject to the FAR 42.709 penalties. FAR § 31.201-6(c)(3).

Directly Associated Costs: Second, the new rule also amends FAR 31.201-6(e) with regard to costs “directly associated” with unallowable costs to emphasize that directly associated costs are unallowable “only if” they are determined to be “material” in accordance with the current criteria set forth in FAR 31.201-6(e)(1) and (e)(2). FAR 31.201-6(e)(1) provides that the materiality of directly associated costs

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should be evaluated in light of “the actual dollar amount,” the “cumulative effect” of all directly associated costs in a cost pool, and the ultimate effect on the cost of Government contracts. FAR 31.201-6(e)(2) provides that salaries of employees who participate in activities that generate unallowable costs “shall be treated as directly associated costs to the extent of time spent on the proscribed activity, provided that costs are material in accordance with . . . e(1).” FAR 31.201-6(e)(2) also provides that the materiality of these salaries should be determined by comparing the time spent in proscribed activities with the total time spent on company activities. Under these rules, a correctly constructed sample that considers directly associated costs should be acceptable for identifying the directly associated costs.

Emphasis on Advance Agreements: Third, the new rule advocates the execution of advance agreements between the contractor and the contracting officer prior to the use of statistical sampling. FAR § 31.201-6(c)(4). Accordingly, the unallowable cost situation was added to the list of examples found at FAR § 31.109(h)(17) “for which advance agreements are particularly important.” The new rule further advocates that the advance agreement “should” specify the “basic characteristics” of the sampling process and that the contracting officer “shall” request input from the cognizant auditor before entering into any agreement. In the absence of an advance agreement, the contractor will bear the burden of proof to demonstrate that the sampling method meets the rule’s criteria (in paragraph c(2)) should an initial review of the facts result in the contracting officer challenging the sampling methods. FAR § 31.201-6(c)(5). Comments by the rulemakers indicate that a lack of an advance agreement places the contractor “at risk” of noncompliance and opens the door to the Government performing its own sampling or even a 100% review of the costs at issue. See 70 CFR 57465 (September 30, 2005).

Impact: The underlying purpose of the amended rule is greater flexibility. Comments by the rulemakers indicate that this flexibility was specifically intended so that the contracting parties could “apply sampling in a manner that maximizes its efficient use.” See 70 CFR 57465 (September 30, 2005). By emphasizing the need for advance agreements, the rule incentivizes contractors and contracting officers to work together to segregate and identify unallowable costs for all billings, claims or proposals applicable to a Government contract. Accordingly, the sampling criteria does leave some room for discretion in that it does not define terms such as “reasonable representation” or what is meant by “large dollar value” or “high risk transaction.” Presumably, these parameters would be defined by the parties in any advance agreement reached. In addition, as a practical matter, the use of statistical sampling may allow contractors to conserve resources formerly spent on identifying and excluding allowable costs on the front end. Finally, while it appears that statistical sampling will now be acceptable as support for proposals, including forward pricing rate proposals, the rule is not intended to conflict with the CAS 405 requirements excluding expressly unallowable costs from proposals. Indeed, the rulemakers have made specific comments that the new rule does not, in their view, conflict with CAS 405 and that statistical sampling “is acceptable for both segregating unallowable costs and verifying that such costs have been properly segregated.” See 70 CFR 57465 (September 30, 2005).

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