

## CHAPTER 7 COST PRINCIPLES

### §7101. Cost Principles. (a) Definitions.

(1) *Actual Costs* are all direct and indirect costs which have been incurred for services rendered, supplies delivered, or construction built, as distinguished from allowable costs only.

(2) *Cost Objective* is any unit of work such as a function, an organizational subdivision, or a contract for which provision is made to accumulate and measure separately the cost of processes, products, jobs, capitalized projects, and similar items. A final cost objective is one that has allocated to it both direct and indirect costs and, in the contractor's accumulation system, is one of the final accumulation points.

### (b) Applicability of Cost Principles.

#### (1) Application.

(a) The cost principles and procedures contained in this Chapter shall be used to determine the allowability of incurred costs for the purpose of reimbursing costs under contract provisions which provide for the reimbursement of costs, provided that any deviation from these cost principles may be made as provided in §7101(k) (Authority to Deviate from Cost Principles), of this Chapter.

(b) The cost principles and procedures set forth in this Chapter may be used as guidance in:

(i) the establishment of contract cost estimates and prices under contracts awarded on the basis of competitive sealed proposals where the award may not be based on adequate price competition (§3110); Sole Source Procurement (§3112); Competitive Selection Procedures (§3114); and architect-engineer and land surveying services (§5108) of these Regulations.

SOURCE: Spelling correction to *contract* in first line. (1/1/1999)

(ii) the establishment of price adjustments for contract changes including contracts that have been let on the basis of competitive sealed bidding or otherwise based on adequate price competition;

(iii) the pricing of termination for

convenience settlements; and

(iv) any other situation in which cost analysis is used. Cost analysis is defined in §3101(a)(2) of these Regulations.

(2) **Limitation.** These cost principles regulations are not applicable to:

(a) the establishment of prices under contracts awarded on the basis of competitive sealed bidding or otherwise based on adequate price competition rather than the analysis of individual, specific cost elements, except that this Chapter does apply to the establishment of adjustments of price for changes made to such contracts;

(b) prices which are fixed by law or regulation; and

(c) prices which are based on established catalogue prices, as defined in §1106(24) (Established Catalogue Price) of these Regulations, or established market prices.

(c) Allowable Costs.

(1) **General.** Any contract cost proposed for estimating purposes or invoiced for cost-reimbursement purposes shall be allowable to the extent provided in the contract and, if inconsistent with these cost principles, approved as a deviation under §7101(k) (Authority to Deviate from Cost Principles) of these Regulations.

The contract shall provide that the total allowable cost of a contract is the sum of the allowable direct costs actually incurred in the performance of the contract in accordance with its terms, plus the properly allocable portion of the allowable indirect costs, less any applicable credits (such as discounts, rebates, refunds, and property disposal income).

(2) **Accounting Consistency.** All costs shall be accounted for in accordance with generally accepted accounting principles and in a manner that is consistent with the contractor's usual accounting practices in charging costs to its other activities. In pricing a proposal, a contractor shall estimate costs in a manner consistent with its cost accounting practices used in accumulating and reporting costs.

(3) **When Allowable.** The contract shall provide that costs shall be allowed to the extent they are:

(a) reasonable, as defined in §7101(d)

(Reasonable Costs);

(b) allocable, as defined in §7101(e) (Allocable

costs);

(c) lawful under any applicable law;

(d) not unallowable under §7101(f)

(Treatment of Specific Costs) or §7101(g) (Costs Requiring Prior Approval to be Allowable as Direct Costs); and

(e) in the case of costs invoiced for reimbursement, actually incurred or accrued and accounted for in accordance with generally accepted accounting principles.

(d) **Reasonable Costs.** Any cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by an ordinarily prudent person in the conduct of competitive business in that industry. In determining the reasonableness of a given cost, consideration shall be given to:

(1) requirements imposed by the contract terms and conditions;

(2) whether the cost is of a type generally recognized as ordinary and necessary for the conduct of the contractor's business or the performance of the contract;

(3) the restraints inherent in, and the requirements imposed by, such factors as generally accepted sound business practices, arms' length bargaining, and federal and state laws and regulations;

(4) the action that a prudent business manager would take under the circumstances, including general public policy and considering responsibilities to the owners of the business, employees, customers, and the territory;

(5) significant deviations from the contractor's established practices which may unjustifiably increase the contract costs; and

(6) any other relevant circumstances.

(e) **Allocable Costs.**

(1) **General.** A cost is allocable if it is assignable or chargeable to one or more cost objectives in accordance with relative benefits received and if it:

(a) is incurred specifically for the contract;

(b) benefits both the contract and other work, and can be distributed to both in reasonable proportion to the benefits received; or

(c) is necessary to the overall operation of the business, although a direct relationship to any particular cost objective may not be evident.

(2) **Allocation Consistency.** Costs are allocable as

direct or indirect costs. Similar costs (those incurred for the same purpose, in like circumstances) shall be treated consistently either as direct costs or indirect costs except as provided by these Regulations. When a cost is treated as a direct cost in respect to one cost objective, it and all similar costs shall be treated as a direct cost for all cost objectives. Further, all costs similar to those included in any indirect cost pool shall be treated as indirect costs. All distributions to cost objectives from a cost pool shall be on the same basis.

(3) **Direct Costs.** A direct cost is any cost which can be identified specifically with a particular final cost objective. A direct cost shall be allocated only to its specific cost objective. To be allowable, a direct cost must be incurred in accordance with the terms of the contract.

(4) **Indirect Costs.**

(a) An indirect cost is one identified with no specific final cost objective or with more than one final cost objective. Indirect costs are those remaining to be allocated to the several final cost objectives after direct costs have been determined and charged directly to the contract or other work as appropriate. Any direct costs of minor dollar amount may be treated as indirect cost, provided that such treatment produces substantially the same results as treating the cost as a direct cost.

(b) Indirect costs shall be accumulated into logical cost groups (or pools), with consideration of the reasons for incurring the costs. Each group should be distributed to cost objectives benefiting from the costs in the group. Each indirect cost group shall be distributed to the cost objectives substantially in proportion to the benefits received by the cost objectives. The number and composition of the groups and the method of distribution should not unduly complicate indirect cost allocation where substantially the same results could be achieved through less precise methods.

(c) The contractor's method of distribution may require examination when:

(i) any substantial difference exists between the cost patterns of the work performed under the contract and contractor's other work;

(ii) any significant change occurs in the

nature of the business, the extent of subcontracting, fixed asset improvement programs, inventories, the volume of sales and production, manufacturing processes, the contractor's products, or other relevant circumstances; or

(iii) indirect cost groups developed for a contractor's primary location are applied to off-site locations. Separate cost groups for costs allocable to off-site locations may be necessary to distribute the contractor's costs on the basis of the benefits accruing to the appropriate cost objectives.

(d) The base period for indirect cost allocation is the one in which such costs are incurred and accumulated for distribution to work performed in that period. Normally, the base period is the contractor's fiscal year. A different base period may be appropriate under unusual circumstances.

In such cases, an appropriate period should be agreed to in advance.

(f) Treatment of Specific Costs.

(1) **Advertising**

(a) Advertising costs are those incurred in using any advertising media when the advertiser has control over the form and content of what will appear, the media in which it will appear, or when it will appear. Advertising media include newspapers, magazines, radio, television, direct mail, trade papers, billboards, window displays, conventions, exhibits, free samples, and the like. All advertising costs except those set forth in Subsection 7101(f)(1)(b) of this Section are unallowable.

(b) The only allowable advertising costs are those for:

- (i) the recruitment of personnel;
- (ii) the procurement of scarce items;
- (iii) the disposal of scrap or surplus materials; and
- (iv) the listing of a business's name and location in a classified directory.

(2) **Bad Debts.** Bad debts include losses arising from uncollectible accounts and other claims, such as dishonored checks, uncollected employee advances, and related collection and legal costs. All bad debt costs are unallowable.

**(3) Contingencies**

(a) contingency costs are contributions to a reserve account for unforeseen costs. Such contingency costs are unallowable except as provided in Subsection 7101(f)(3)(b) of this Section.

(b) or the purpose of establishing a contract cost estimate or price in advance of performance of the contract, recognition of uncertainties within a reasonably anticipated range of costs may be required and is not prohibited by this Subsection. However, where contract clauses are present which serve to remove risks from the contractor, there shall not be included in the contract price a contingency factor for such risks. Further, contributions to a reserve for self-insurance in lieu of, and not in excess of, commercially available liability insurance premiums are allowable as an indirect charge.

**(4) Depreciation and Use allowances**

(a) Depreciation and use allowances, that is, the allowance made for fully depreciated assets, are allowable to compensate contractors for the use of buildings, capital improvements, and equipment or for the provision of such facilities on a standby basis for subsequent use when such facilities are temporarily idle because of suspensions or delays not caused by the contractor, not reasonably foreseeable, and not otherwise avoidable when the contract was awarded. Depreciation is a method of allocating the acquisition cost of an asset to periods of its useful life. Useful life refers to the asset's period of economic usefulness in the particular contractor's operation as distinguished from its physical life. Use allowances provide compensation in lieu of depreciation or other equivalent costs. Consequently, these two methods may not be combined to compensate contractors for the use of any one type of property.

(b) The computation of depreciation or use allowances shall be based on acquisition costs. When the acquisition costs are unknown, reasonable estimates may be used.

(c) Depreciation shall be computed using any generally accepted method, provided that the method is consistently applied and results in

equitable charges considering the use of the property. The straight-line method of depreciation is preferred unless the circumstances warrant some other method. However, the territory will accept any method which is accepted by the Internal Revenue Service.

(d) In order to compensate the contractor for use of depreciated, contractor-owned property which has been fully depreciated on the contractor's books and records and is being used in the performance of a contract, use allowances may be allowed as a cost of that contract. Use allowances are allowable, provide that they are computed in accordance with an established industry or government schedule or other method mutually agreed upon by the parties. If a schedule is not used, factors to consider in establishing the allowance are the original cost, remaining estimated useful life, the reasonable fair market value, and the effect of any increased maintenance or decreased efficiency.

**(5) Entertainment**

(a) Entertainment costs include costs of amusements, social activities, and incidental costs relating thereto, such as meals, beverages, lodging, transportation, and gratuities. Entertainment costs are unallowable.

(b) Nothing herein shall make unallowable a legitimate expense for employee morale, health, welfare, food service, or lodging costs; except that where a net profit is generated by such services, it shall be treated as a credit as provided in §7101(h) (Applicable Credits). This Section shall not make unallowable costs incurred for meetings or conferences, including, but not limited to, costs of food, rental facilities, and transportation where the primary purpose of incurring such cost is the dissemination of technical information or the stimulation of production.

**(6) Fines and Penalties.** Fines and penalties include all costs incurred as the result of violations of, or failure to comply with, federal and local laws and regulations. Fines and penalties are unallowable costs unless incurred as a direct result of compliance with specific provisions of the contract or written instructions of the Procurement Officer. To the extent that worker's compensation is considered by local law

to constitute a fine or penalty, it shall not be an unallowable cost under this Subsection.

(7) **Gifts, Contributions, and Donations.** A gift is property transferred to another person without the other person providing return consideration of equivalent value. Reasonable costs for employee morale, health, welfare, food services, or lodging are not gifts and are allowable. Contributions and donations are property transferred to a nonprofit institution which are not transferred to exchange for supplies or services of equivalent fair market value rendered by a nonprofit institution. Gifts, contributions, and donations are unallowable.

(8) **Interest Costs**

(a) Interest is generally an unallowable cost for purposes of determining the original contract price. Compensation for any interest expense incurred in connection with work originally contemplated under the contract will be deemed to be included in the fee or profit negotiated on the contract.

(b) Imputed interest on a contractor's expenditures made to pay allowable costs which are allocable to the performance of work required by change orders, suspension of work, or other acts of the territory requiring additional work over and above that required by the original contract (hereinafter called "Additional Work") shall be an allowable cost. Imputed interest is an allowable cost in relation to such Additional Work in a negotiated settlement, if one can be agreed upon, or to the extent that it is determined administratively or judicially that the territory is liable for such Additional Work. Such imputed interest shall be computed on expenditures from the date or dates on which the contractor made expenditures for the performance of such Additional Work until the date of payment therefor by the territory. The rate of interest shall be the prevailing prime rate charged by banks in this territory as determined by the Territorial Auditor or Comptroller, at the time or times the contractor made such expenditures for Additional Work. Imputed interest on the costs of Additional Work shall not be allowable to the extent that it is otherwise recovered as profit, fee, or as interest on contractor claims pursuant to § 9107 (Interest) of

these Regulations.

**(9) Losses Incurred Under Other Contracts.** A loss is the excess of costs over income earned under a particular contract. Losses may include both direct and indirect costs. A loss incurred under one contract may not be charged to any other contract.

**(10) Material Costs**

(a) Material costs are the costs of all supplies, including raw materials, parts, and components (whether acquired by purchase from an outside source or acquired by transfer from any division, subsidiary, or affiliate under the common control of the contractor), which are acquired in order to perform the contract. Material costs are allowable, subject to Subsection 7101(f)(10)(b) and Subsection 7101(f)(10)(c) of this Section. In determining material costs, consideration shall be given to reasonable spoilage, reasonable inventory losses, and reasonable overages.

(b) Material costs shall include adjustments for all available discounts, refunds, rebates, and allowances which the contractor reasonably should take under the circumstances, and for credits for proceeds the contractor received or reasonably should receive from salvage and material returned to suppliers.

(c) Allowance for all materials transferred from any division (including the division performing the contract), subsidiary, or affiliate under the common control of the contractor shall be made on the basis of costs incurred by the transferor (determined in accordance with this Chapter), except the transfer may be made at the established price provided the price of materials is not determined to be unreasonable by the Procurement Officer, the price is not higher than the transferor's current sales price to its most favored customer for a like quantity under similar payment and delivery conditions, and the price is established either:

(i) by the established catalogue price, as defined in § 1106(24), of these Regulations; or

(ii) by the lowest price offer obtained as a result of competitive sealed bidding or competitive sealed proposals conducted with other businesses that normally produce the item in similar quantities.

(11) Taxes

(a) Except as limited in Subsection 7101(11)(b) of this Section, all allocable taxes which the contractor is required to pay and which are paid and accrued in accordance with generally accepted accounting principles are allowable.

(b) The following costs are unallowable:

(i) federal, local income taxes and federal excess profit taxes;

(ii) all taxes from which the contractor could have obtained an exemption, but failed to do so, except where the administrative cost of obtaining the exemption would have exceeded the tax savings realized from the exemption;

(iii) any interest, fines, or penalties paid on delinquent taxes unless incurred at the written direction of the Procurement Officer; and

(iv) income tax accruals designed to account for the tax effects of differences between taxable income and pretax income as reflected by the contractor's books of account and financial statements.

(c) Any refund of taxes which were allowed as a direct cost under the contract shall be credited to the contract. Any refund of taxes which were allowed as an indirect cost under a contract shall be credited to the indirect cost group applicable to any contracts being priced or costs being reimbursed during the period in which the refund is made.

(d) Direct government charges for services, such as water, or capital improvements, such as sidewalks, are not considered taxes and are allowable costs.

**(g) Costs Requiring Prior Approval to be Allowable as Direct Costs**

(1) **General.** The costs described in Subsection 7101(g)(2) through 7101(g)(5) of this Section are allowable as direct costs to cost-reimbursement type contracts to the extent that they have been approved in advance by the Procurement Officer. In other situations the allowability of these costs shall be determined in accordance with general standards set out in these cost principles.

(2) **Pre-Contract Costs.** Pre-contract costs are

those incurred in anticipation of, and prior to, the effective date of the contract. Such costs are allowable to the extent that they would have been allowable if incurred after the date of the contract; provided that, in the case of a cost-reimbursement type contract, a special provision must be inserted in the contract setting forth the period of time and maximum amount of cost which will be covered as allowable pre-contract costs.

(3) **Bid and Proposal Costs.** Bid and proposal costs are the costs incurred in preparing, submitting, and supporting bids and proposals. Reasonable ordinary bid and proposal costs are allowable as indirect costs in accordance with these cost principles regulations. Bid and proposal costs are allowable as direct costs only to the extent that they are specifically permitted by a provision of the contract or solicitation document. Where bid and proposal costs are allowable as direct costs, to avoid double accounting, the same bid and proposal costs shall not be charged as indirect costs.

(4) **Insurance**

(a) Ordinary and necessary insurance costs are normally allowable as indirect costs. Direct insurance costs are the costs of obtaining insurance in connection with performance of the contract or contributions to a reserve account for the purpose of self-insurance. Self-insurance contributions are allowable only to the extent of the cost to the contractor to obtain similar insurance.

(b) Insurance costs may be approved as a direct cost only if the insurance is specifically required for the performance of the contract.

(c) Actual losses which should reasonably have been covered by permissible insurance or were expressly covered by self-insurance are unallowable unless the parties expressly agree otherwise in the terms of the contract.

(5) **Litigation Costs.** Litigation costs include all filing fees, legal fees, expert witness fees, and all other costs involved in litigating claims in court or before an administrative board. Litigation costs incident to the contract are allowable as indirect costs in accordance with these cost principles regulations except that costs incurred in litigation by or against the territory are unallowable.

**(h) Applicable Credits**

(1) **Definitions and Examples.** Applicable credits are receipts or price reductions which offset or reduce expenditures allocable to contracts as direct or indirect costs. Examples include purchase discounts, rebates, allowances, recoveries or indemnification for losses, sale of scrap and surplus equipment and materials, adjustments for overpayment or erroneous charges, and income from employee recreational or incidental services and food sales.

(2) **Reducing Costs.** Credits shall be applied to reduce related direct or indirect costs.

(3) **Refund.** The territory shall be entitled to a cash refund if the related expenditures have been paid to the contractor under a cost-reimbursement type contract.

**(i) Advance Agreements**

(1) **Purpose.** Both the territory and the contractor should seek to avoid disputes and litigation arising from potential problems by providing in the terms of the solicitation and the contract the treatment to be accorded special or unusual costs which are expected to be incurred.

(2) **Form Required.** Advance agreements may be negotiated either before or after contract award, depending upon when the parties realize the cost may be incurred, but shall be negotiated before a significant portion of the cost covered by the agreement has been incurred. Advance agreements shall be in writing, executed by both contracting parties, and incorporated in the contract.

(3) **Limitation on Costs Covered.** An advance agreement shall not provide for any treatment of costs inconsistent with these costs principles regulations unless a determination has been made pursuant to §7101(k) (Authority to Deviate from Cost Principles), of these Regulations.

**(j) Use of Federal Cost Principles**

(1) **Cost Negotiations.** In dealing with contractors operating according to federal cost principles, such as Defense Acquisition Regulations, § 15, or Federal Procurement Regulations, Part 1-15, the Procurement Officer, after notifying the contractor, may use the federal cost principles as guidance in contract negotiations, subject to Subsection 7101(j)(2) of this Section.

**(2) Incorporation of Federal Cost Principles:**

**Conflicts Between Federal Principles and this Chapter.** All requirements set forth in federal assistance instruments applicable to contracts let by the territory under a federal assistance program must be satisfied. Therefore, to the extent that the cost principles which are specified in the assistance instrument conflict with the cost principles issued pursuant to Chapter 7 (Cost Principles) of these Regulations, the former shall control.

(k) **Authority to Deviate from Cost Principles.** When the best interest of the territory would be served by a deviation, the Procurement Officer may deviate from the cost principles set forth in these regulations; provided that a written determination shall be made by such officer specifying the reasons for the deviation. A copy of such determination shall be filed promptly with the Chief Procurement Officer and such determination shall be effective only upon approval by the Chief Procurement Officer and upon incorporation into the contract. However, all costs must be reasonable, lawful, allocable, and accounted for in accordance with generally accepted accounting principles to be reimbursed, and a deviation shall not contravene this principle.