

# ARIZONA DEPARTMENT OF TRANSPORTATION

## COST ALLOWABILITY GUIDELINES

### FOR QUALIFICATION BASE SELECTED CONSULTANTS AND SUBCONSULTANTS

#### INTRODUCTION

The Cost Allowability Guidelines are presented to assist Consultants and Subconsultants in determining the allowability of costs to be included in Derivation of Cost proposals prepared for the Arizona Department of Transportation ("ADOT").

The ADOT Office of Audit & Analysis will also utilize these Guidelines in the performance of prenegotiation reviews, desk cost reviews, overhead and cost audits.

Incorporated into these Guidelines is ADOT's Engineering Consultants Section Information Bulletin 98-16 (July 30, 1998) referencing:

- Current Federal Acquisition Regulations ("FAR"), Title 48 CFR, Chapter 1, Part 31 (Contract Cost Principles and Procedures),
- Current Cost Accounting Standards, if applicable, (Title 48 CFR, Chapter 1, Part 30 and Chapter 99
- ADOT's Advance Agreement Checklist, and
- Engineering Consultants Section (ECS) Information Bulletin 98-05, Accounting for Other Direct Costs.

The attached guidelines are intended as a summary only, and are not to be considered a complete statement of cost principles. Many of the quotes that follow, which were extracted directly from Subpart 31.2, include references to other sections of the FAR. The reader will need to refer to Subpart 31.2 for the complete text. In addition, the FAR is constantly being updated. It is important that revisions be reviewed on a regular basis; as such revisions will be implemented as they are made available to the public.

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## A. General Cost Requirements:

### 1. Direct Costs

All direct costs (or expenses) will be identified by type and cost rate in cost proposals and negotiations.

- Cost items not identified as direct costs or expenses will not be considered for reimbursement
- All unbilled or unreimbursable direct costs must be included in Direct Costs.
- Any costs to be charged directly to the contract that were not incorporated in the initial contract proposal(s) are subject either to a contract modification or have prior ADOT approval for a change in accounting policy.

See the Advance Agreement Check List.

#### a. Direct Labor:

- All *Project* (direct) labor shall be accumulated in a Direct Labor Cost Base. Actual hours worked must be costed by either one of three acceptable methods of accounting: (1) using actual labor rates; (2) using standard labor rates with cost variances going into overhead or, (3) average cost labor rates whereby all cost variances are allocated to every hour worked. It is required that all hours for an individual be charged to the Direct Labor Cost Base at the same rate--to be determined consistently for all *Projects*.
- All *Project* labor, including over-runs, must be included in the Direct Labor Cost Base. The Consultant/Subconsultant must follow a consistent policy of accounting for all projects.
- All hours worked on projects must be charged to the project worked. Direct labor worked, but not compensated, or compensated as "compensatory leave" must be included in the direct labor base. (When salaried employees (including principals) work more than 40 hours in any given week, those employees must account for all hours worked.) The cost of those hours must be accounted for following either the second or third acceptable method noted in the first bullet under Direct Labor.
- Direct labor shall be traceable from the general ledger through the job cost records to the payroll records. However, for partners and sole proprietors who may not be paid an hourly wage or salary, the direct labor charges shall be based upon compensation in lieu of salary, previously agreed to by ADOT. [See B. 31.205-6(b)(2)(i)]

- The accounting period to be used to accumulate the Direct Labor Cost Base will normally be the Consultant/Subconsultant's fiscal year, to be consistent with 31.203(e).
- If a Consultant/Subconsultant's records fail to support the Direct Labor Cost Base as defined above, its' accounting system will be deemed unacceptable. The contracting officer may disallow all or part of a claimed cost that is improperly supported--see 31.201-2(d) at A. 3.

**b. Other Direct Costs:**

- Billing of indirect costs to other customers and offsetting the billing to the appropriate indirect cost pool will only be allowed on an interim basis for a current fiscal year. (See ECS Information Bulletin 98-05)

**2. Indirect Costs and Allocation Methods**

To the extent that both allowable and unallowable costs have been commingled within one account, or group of accounts, it shall be the responsibility of the Consultant/Subconsultant to segregate unallowable costs.

**3. Allocability of Costs**

- The prevalent base normally used by Consultants/Subconsultants to allocate indirect (Overhead) costs to Projects, is the cost of direct labor dollars charged to those projects. Some portion of indirect costs, particularly when there are allocations from a Consultant/Subconsultant's regional or home office, may be allocated using some other allocation base that is more relevant to a fair distribution of cost. Where costs from another office are allocated to the office selected to negotiate an ADOT contract, the Consultants/Subconsultants will be expected to explain, in writing: (1) why such costs are allocable and (2) the reason for the bases selected to allocate the costs.
- Consultants/Subconsultants that spend time and/or resources in connection with acquiring other firms, reorganizing the existing business, raising capital (including long-term debt or net worth), etc., will be expected to identify and disclose the applicable expenditures for employees' time, directly associated costs (A. 7.), related out-of-pocket expenses, and for related professional and/or consultant services, as unallowable costs. (See B. 31.205-27.) Firms qualified to provide more than one engineering discipline or specialty must be able to substantiate separate overhead rates for each of the following:
  - Construction Administration
  - Design
  - Geotechnical Services
  - Supplemental Services

#### **4. Accounting for Unallowable Costs**

The Schedule of Indirect (Overhead) Costs provided to ADOT shall be supplemented with a brief description and amount of any unallowable costs the Consultant/Subconsultant has identified.

#### **B. Selected Costs:**

##### **31.205-3 Bad Debts**

"Other claims" includes any uncollectible item from employees, shareholders, or other non-customers.

##### **31.205-5 Civil Defense Costs**

Civil defense costs, if applicable, will be allowed only as a direct cost.

##### **31.205-6 Compensation for Personal Services**

###### **1. *Salaries and wages, including bonuses:***

ADOT will evaluate Consultants/Subconsultants' compensation costs in three groups of employees:

- Non-managerial technically qualified employees whose time is predominantly charged to *Projects*,
- Managerial employees, including executives, (regardless of whether they charge time to *Projects*), and
- Clerical employees whose time is predominantly not charged to *Projects*.

###### **Non-managerial technical employees, whose time is predominantly charged to Projects:**

The compensation rates will be evaluated by classification; these rates must be in line with the industry compensation rates within the State of Arizona.

###### **Managerial employees, including executives:**

For most firms, the total annual compensation on which these employees pay income taxes, plus any deferred compensation, if applicable, will be evaluated for reasonableness.

###### **Clerical employees, whose time is predominantly not charged to Projects:**

The compensation will be evaluated by position. Compensation paid to these employees must be in line with compensation paid for similar positions in the State of Arizona. Compensation in excess of the amounts determined, plus the directly associated costs, may not be allowed for reimbursement purposes.

## **Indirect Labor:**

For the determination of reasonableness see 31.201-3(a) and 31.205-6(b).

2. ***Bonuses and incentive compensation*** - 31.205-6(f)(1) identifies five categories of bonuses and incentive compensation:

### **Implementation of Cost Principle**

Consultants/Subconsultants must be able to justify bonuses as performance based.

If owners of multi-employee firms grant bonuses only to themselves, such bonuses, along with directly associated costs, will be disallowed as such costs are considered a distribution of profits.

3. ***Severance pay*** - 31.205-6(g)(1)

For severance pay to be allowable, the firm must have a documented policy and practice, applicable to all employees, to grant severance pay to those employees whose employment is involuntarily terminated, unless the termination was for cause.

4. ***Backpay*** - 31.205-6(h)(1)

If allowable backpay is claimed in any Consultant/Subconsultant's indirect (Overhead) cost rate, the amount, year applicable, and reason for the backpay must be explained. If the backpay affects years in which an ADOT contract was being worked, ADOT will allow such costs to be included in the proposed Overhead rate.

5. **31.205-6(i) states**, "Compensation based on changes in the prices of corporate securities or corporate security ownership, such as stock options, stock appreciation rights, phantom stock plans, and junior stock conversions."

6. ***Pension costs*** - 31.205-6(j)(1)

(1) To be considered allowable, pension costs must be made pursuant to a pension plan that is IRS qualified ("*Plan*"). If any changes in a *Plan* have been made since the last IRS determination letter, a copy of a current IRS determination letter or a letter of determination (from an authority acceptable to ADOT), that such changes have not disqualified the *Plan*, must be provided to ADOT.

(2) Should a firm have an *early retirement incentive plan* that meets the requirements of 31.205-6(j)(7), the costs of this plan will be accumulated with other pension costs. A determination of the total allowable amount of pension costs will then be made.

(3) For the determination of reasonableness see 31.201-3(a) and 31.205-6(b).

**7. *Deferred Compensation and ESOPs:***

Interest on leveraged ESOPs is not allowable. However, on contracts entered into before January 1, 1997, ADOT will not question the cost of interest on leveraged deferred compensation ESOPs.

**8. *Compensation incidental to business acquisitions* - 31.205-6(l):**

Generally, any payments resulting from special compensation arrangements that arise out of the sale or acquisition of a business are unallowable.

**9. *Fringe benefits* - 31.205-6(m)(1)**

- **Fringe benefits as a group** - This group of costs needs to be scheduled, by type, for review.
- **Employee group insurance** - Usual and customary health, life, and disability insurance will be considered allowable. Each plan will be evaluated for reasonableness.
- **Compensated personal absence benefits** - The costs for usual and customary numbers of days/hours will be considered allowable for the following categories:

- (1) Bereavement leave
- (2) Holidays
- (3) Jury duty leave
- (4) Military leave
- (5) Sick leave
- (6) Training leave (See 31.205-44(c) for possible pay limitation.)
- (7) Vacation leave
- (8) Other paid leave

Firms combining more than one of these categories into a combined leave policy will have the burden of showing that aggregate leave policies are reasonable.

The costs of any other forms of compensated personal absence will not be allowed. If a firm considers some other form of compensated personal absence to be a reasonable and allocable cost, the firm must request that ADOT review such cost during the negotiation phase of the contract.

- **Educational reimbursement** - For the cost of educational reimbursement to be allowable, the firm must have a written policy and practice that applies to all employees. If a firm claims this cost for reimbursement, it must be separately identified for review. In addition, the policy must meet the tests of allowability set forth in 31.205-44.

- **Other fringe benefits** - The costs of the following benefits are unallowable:
  - (1) Legal or financial aid, limited to owners of the firm.
  - (2) Social club memberships. See 31.205-13.
  - (3) Costs not covered elsewhere in 31.205-6.

**10. Postretirement benefits other than pensions (PRB)** - 31.205-6(o)(1) states, "PRB covers all benefits, other than cash benefits and life insurance benefits paid by pension plans, provided to employees, their beneficiaries, and covered dependents during the period following the employees' retirement. Benefits encompassed include, but are not limited to, postretirement health care; life insurance provided outside a pension plan; and other welfare benefits such as tuition assistance, day care, legal services, and housing subsidies provided after retirement."

31.205-6(o)(2) states, "To be allowable, PRB costs must be reasonable and incurred pursuant to law, employer-employee agreement, or an established policy of the contractor."

There are other requirements affecting allowability within 31.205-6(o) that should be carefully reviewed if PRB costs are being claimed by the Consultant/Subconsultant.

**11. Personal Expenses.** Costs of personal expenses, including but not limited to: personal meals and entertainment, personal travel, residence, telephone, maids, vehicles or equipment, and related expenses, are unallowable unless the business purpose of the expense is clearly documented.

### **31.205-10 Cost of Money**

Many Consultants/Subconsultants include "Cost of Money" in their Overhead cost pool. It is clear from reading FAR 31.205-10 that "Cost of Money" is not a component of, and should never be included in, Overhead cost pools (See the Advanced Agreement Check List).

### **31.205-11 Depreciation**

Depreciation in excess of IRS depreciation guideline lives will not be allowed. In addition, any Section 179 deduction claimed must be capitalized and depreciated in accordance with IRS depreciation guideline lives or Generally Accepted Accounting Principles.

### **31.205-13 Employee Morale, Health and Welfare**

To ensure there is no misunderstanding, costs associated with company parties or picnics (Christmas, Spring, Independence Day, etc.) are unallowable.

### **31.205-18 Independent Research and Development and Bid and Proposal Costs**

IR&D costs will not be allowable unless it can be demonstrated that such costs will have a beneficial impact on ADOT contracts.



The Consultant/Subconsultant should use due care in accounting for B&P cost. ADOT reserves the right to disallow estimated B&P costs that have not been properly documented.

### **31.205-19 Insurance and Indemnification**

Regarding premiums for property insurance (31.205-19(a)(2)(iii)), the cost of property insurance premiums for insurance coverage in excess of the net book value of insured assets is unallowable.

Legal and professional fees paid, and directly associated costs, e.g., employees' time spent, in connection with financing or refinancing long-term liabilities are unallowable (see 31.205-27(a)(3)).

### **31.205-22 Lobbying and Political Activity Costs**

Costs associated with lobbying and political activities at the Federal, State, or local level are unallowable. ADOT strongly encourages all Consultants and Subconsultants to read carefully 31.205-22(a)(1)-(6).

### **31.205-30 Patent Costs**

No allowance will be made for such costs unless negotiated.

### **31.205-31 Plant Reconversion Costs**

This cost principle does not apply to Consultants\Subconsultants.

### **31.205-33 Professional and Consultant Service Costs**

The costs of professional or consultant services (rendered in connection with "organization activities" as defined in 31.205-27) are unallowable.

### **31.205-35 Relocation Costs**

The firm must have a documented policy that conforms to all the subparagraphs under 31.205-35.

Unless otherwise requested by ADOT, any relocation costs allowed by a Consultant/Subconsultant under its documented policy will be charged appropriately (either as an indirect (Overhead) cost or as a direct cost).

Relocation by a Consultant/Subconsultant to fulfill an ADOT contract will only be allowable under the following conditions:

- ADOT specifically requests the services of an employee the Consultant/Subconsultant was not planning to work on the contact, and,

- The nature of the service rendered would make it imperative for such an employee to move to a location on or near the jobsite.

### **31.205-37 Royalties and Other Costs for Use of Patents**

No allowance will be made for such costs, except for royalty costs associated with regular purchases of commercially available software or information databases, unless negotiated.

### **31.205-40 Special Tooling and Special Test Equipment Costs**

No allowance will be made for such costs unless negotiated.

### **31.205-41 Taxes**

Any income or excess profits taxes (including state, county or municipal) paid or accrued are unallowable.

Foreign taxes of any kind are unallowable.

### **31.205-42 Termination Costs**

Except for terminations for Consultant default, the Consultant will be compensated only for work performed, based upon consideration of the audit report, engineering evaluation, and any other applicable factors described in the contract.

### **31.205-45 Transportation Costs**

This cost principle generally applies to contractors providing products, not services.

### **31.205-46 Travel Costs**

- Costs for transportation by motor vehicle may be based on mileage rates, actual costs incurred, or a combination thereof, provided the method used results in a reasonable charge.
- Mileage rates for company-owned vehicles will not be allowed as a direct cost unless such company-owned vehicles are included in a separate cost pool, apart from the customary overhead cost pool. See the Advance Agreement Check List.
- The State of Arizona Travel Policy shall have precedence in determining allowability of Travel Costs, except that mileage rates may not exceed annually published IRS guidelines.