

Subpart 42.7—Indirect Cost Rates

42.700 Scope of subpart.

This subpart prescribes policies and procedures for establishing—

- (a) Billing rates; and
- (b) Final indirect cost rates.

42.701 Definition.

“Billing rate,” as used in this subpart, means an indirect cost rate—

- (1) Established temporarily for interim reimbursement of incurred indirect costs; and
- (2) Adjusted as necessary pending establishment of final indirect cost rates.

42.702 Purpose.

(a) Establishing final indirect cost rates under this subpart provides—

- (1) Uniformity of approach with a contractor when more than one contract or agency is involved;
- (2) Economy of administration; and
- (3) Timely settlement under cost-reimbursement contracts.

(b) Establishing billing rates provides a method for interim reimbursement of indirect costs at estimated rates subject to adjustment during contract performance and at the time the final indirect cost rates are established.

42.703 General.

42.703-1 Policy.

(a) A single agency (see [42.705-1](#)) shall be responsible for establishing final indirect cost rates for each business unit. These rates shall be binding on all agencies and their contracting offices, unless otherwise specifically prohibited by statute. An agency shall not perform an audit of indirect cost rates when the contracting officer determines that the objectives of the audit can reasonably be met by accepting the results of an audit that was conducted by any other department or agency of the Federal Government ([10 U.S.C. 2313\(d\)](#) and [41 U.S.C. 254d\(d\)](#)).

(b) Billing rates and final indirect cost rates shall be used in reimbursing indirect costs under cost-reimbursement contracts and in determining progress payments under fixed-price contracts.

(c) To ensure compliance with [10 U.S.C. 2324\(a\)](#) and [41 U.S.C. 256\(a\)](#)—

- (1) Final indirect cost rates shall be used for contract closeout for a business unit, unless the quick-closeout procedure in [42.708](#) is used. These final rates shall be binding for all cost-reimbursement contracts at the business unit, subject

to any specific limitation in a contract or advance agreement; and

(2) Established final indirect cost rates shall be used in negotiating the final price of fixed-price incentive and fixed-price redeterminable contracts and in other situations requiring that indirect costs be settled before contract prices are established, unless the quick-closeout procedure in [42.708](#) is used. [1010](#)

42.703-2 Certificate of indirect costs.

(a) *General.* In accordance with [10 U.S.C. 2324\(h\)](#) and [41 U.S.C. 256\(h\)](#), a proposal shall not be accepted and no agreement shall be made to establish final indirect cost rates unless the costs have been certified by the contractor.

(b) *Waiver of certification.* (1) The agency head, or designee, may waive the certification requirement when—

(i) It is determined to be in the interest of the United States; and

(ii) The reasons for the determination are put in writing and made available to the public.

(2) A waiver may be appropriate for a contract with—

(i) A foreign government or international organization, such as a subsidiary body of the North Atlantic Treaty Organization;

(ii) A state or local government subject to OMB Circular A-87;

(iii) An educational institution subject to OMB Circular A-21; and

(iv) A nonprofit organization subject to OMB Circular A-122.

(c) *Failure to certify.* (1) If the contractor has not certified its proposal for final indirect cost rates and a waiver is not appropriate, the contracting officer may unilaterally establish the rates.

(2) Rates established unilaterally should be—

(i) Based on audited historical data or other available data as long as unallowable costs are excluded; and

(ii) Set low enough to ensure that unallowable costs will not be reimbursed.

(d) *False certification.* The contracting officer should consult with legal counsel to determine appropriate action when a contractor’s certificate of final indirect costs is thought to be false.

(e) *Penalties for unallowable costs.* [10 U.S.C. 2324\(a\)](#) through (d) and [41 U.S.C. 256\(a\)](#) through (d) prescribe penalties for submission of unallowable costs in final indirect cost rate proposals (see [42.709](#) for penalties and contracting officer responsibilities).

(f) *Contract clause.* (1) Except as provided in paragraph (f)(2) of this subsection, the clause at [52.242-4](#), Certification of Final Indirect Costs, shall be incorporated into all solicitations and contracts which provide for establishment of final indirect cost rates.

(2) The Department of Energy may provide an alternate clause in its agency supplement for its Management and Operating contracts.

42.704 Billing rates.

(a) The contracting officer (or cognizant Federal agency official) or auditor responsible under [42.705](#) for establishing the final indirect cost rates also shall be responsible for determining the billing rates.

(b) The contracting officer (or cognizant Federal agency official) or auditor shall establish billing rates on the basis of information resulting from recent review, previous rate audits or experience, or similar reliable data or experience of other contracting activities. In establishing billing rates, the contracting officer (or cognizant Federal agency official) or auditor should ensure that the billing rates are as close as possible to the final indirect cost rates anticipated for the contractor's fiscal period, as adjusted for any unallowable costs. When the contracting officer (or cognizant Federal agency official) or auditor determines that the dollar value of contracts requiring use of billing rates does not warrant submission of a detailed billing rate proposal, the billing rates may be established by making appropriate adjustments from the prior year's indirect cost experience to eliminate unallowable and nonrecurring costs and to reflect new or changed conditions.

(c) Once established, billing rates may be prospectively or retroactively revised by mutual agreement of the contracting officer (or cognizant Federal agency official) or auditor and the contractor at either party's request, to prevent substantial overpayment or underpayment. When agreement cannot be reached, the billing rates may be unilaterally determined by the contracting officer (or cognizant Federal agency official).

(d) The elements of indirect cost and the base or bases used in computing billing rates shall not be construed as determinative of the indirect costs to be distributed or of the bases of distribution to be used in the final settlement.

(e) When the contractor provides to the cognizant contracting officer the certified final indirect cost rate proposal in accordance with [42.705-1\(b\)](#) or [42.705-2\(b\)](#), the contractor and the Government may mutually agree to revise billing rates to reflect the proposed indirect cost rates, as approved by the Government to reflect historically disallowed amounts from prior years' audits, until the proposal has been audited and settled. The historical decrement will be determined by either the cognizant contracting officer ([42.705-1\(b\)](#)) or the cognizant auditor ([42.705-2\(b\)](#)).

42.705 Final indirect cost rates.

(a) Final indirect cost rates shall be established on the basis of—

- (1) Contracting officer determination procedure (see [42.705-1](#)), or
- (2) Auditor determination procedure (see [42.705-2](#)).

(b) Within 120 days (or longer period, if approved in writing by the contracting officer,) after settlement of the final annual indirect cost rates for all years of a physically complete contract, the contractor must submit a completion invoice or voucher reflecting the settled amounts and rates. To determine whether a period longer than 120 days is appropriate, the contracting officer should consider whether there are extenuating circumstances, such as the following:

- (1) Pending closeout of subcontracts awaiting Government audit.
- (2) Pending contractor, subcontractor, or Government claims.
- (3) Delays in the disposition of Government property.
- (4) Delays in contract reconciliation.
- (5) Any other pertinent factors.

(c)(1) If the contractor fails to submit a completion invoice or voucher within the time specified in paragraph (b) of this section, the contracting officer may—

- (i) Determine the amounts due to the contractor under the contract; and
- (ii) Record this determination in a unilateral modification to the contract.

(2) This contracting officer determination must be issued as a final decision in accordance with [33.211](#).

42.705-1 Contracting officer determination procedure.

(a) *Applicability and responsibility.* Contracting officer determination shall be used for the following, with the indicated cognizant contracting officer (or cognizant Federal agency official) responsible for establishing the final indirect cost rates:

(1) Business units of a multidivisional corporation under the cognizance of a corporate administrative contracting officer (see [Subpart 42.6](#)), with that officer responsible for the determination, assisted, as required, by the administrative contracting officers, assigned to the individual business units. Negotiations may be conducted on a coordinated or centralized basis, depending upon the degree of centralization within the contractor's organization.

(2) Business units not under the cognizance of a corporate administrative contracting officer, but having a resident administrative contracting officer (see [42.602](#)), with that officer responsible for the determination. For this purpose, a nonresident administrative contracting officer is considered as resident if at least 75 percent of the administrative contracting officer's time is devoted to a single contractor.

(3) For business units not included in paragraph (a)(1) or (a)(2) of this subsection, the contracting officer (or cognizant Federal agency official) will determine whether the rates will be contracting officer or auditor determined.

- (4) Educational institutions (see [42.705-3](#)).
- (5) State and local governments (see [42.705-4](#)).

(6) Nonprofit organizations other than educational and state and local governments (see [42.705-5](#)).

(b) *Procedures.* (1) In accordance with the Allowable Cost and Payment clause at [52.216-7](#), the contractor shall submit to the contracting officer (or cognizant Federal agency official) and to the cognizant auditor a final indirect cost rate proposal. The required content of the proposal and supporting data will vary depending on such factors as business type, size, and accounting system capabilities. The contractor, contracting officer, and auditor must work together to make the proposal, audit, and negotiation process as efficient as possible. Accordingly, each contractor shall submit an adequate proposal to the contracting officer (or cognizant Federal agency official) and auditor within the 6-month period following the expiration of each of its fiscal years. Reasonable extensions, for exceptional circumstances only, may be requested in writing by the contractor and granted in writing by the contracting officer. A contractor shall support its proposal with adequate supporting data. For guidance on what generally constitutes an adequate final indirect cost rate proposal and supporting data, contractors should refer to the Model Incurred Cost Proposal in Chapter 6 of the Defense Contract Audit Agency Pamphlet No. 7641.90, Information for Contractors, available via the Internet at <http://www.dcaa.mil>.

(2) The auditor shall submit to the contracting officer (or cognizant Federal agency official) an advisory audit report identifying any relevant advance agreements or restrictive terms of specific contracts.

(3) The contracting officer (or cognizant Federal agency official) shall head the Government negotiating team, which includes the cognizant auditor and technical or functional personnel as required. Contracting offices having significant dollar interest shall be invited to participate in the negotiation and in the preliminary discussion of critical issues. Individuals or offices that have provided a significant input to the Government position should be invited to attend.

(4) The Government negotiating team shall develop a negotiation position. Pursuant to [10 U.S.C. 2324\(f\)](#) and [41 U.S.C. 256\(f\)](#), the contracting officer shall—

(i) Not resolve any questioned costs until obtaining—

(A) Adequate documentation on the costs; and

(B) The contract auditor's opinion on the allowability of the costs.

(ii) Whenever possible, invite the contract auditor to serve as an advisor at any negotiation or meeting with the contractor on the determination of the contractor's final indirect cost rates.

(5) The cognizant contracting officer shall—

(i) Conduct negotiations;

(ii) Prepare a written indirect cost rate agreement conforming to the requirements of the contracts;

(iii) Prepare, sign, and place in the contractor general file (see [4.801\(c\)\(3\)](#)) a negotiation memorandum covering—

(A) The disposition of significant matters in the advisory audit report;

(B) Reconciliation of all costs questioned, with identification of items and amounts allowed or disallowed in the final settlement as well as the disposition of period costing or allocability issues;

(C) Reasons why any recommendations of the auditor or other Government advisors were not followed; and

(D) Identification of cost or pricing data submitted during the negotiations and relied upon in reaching a settlement; and

(iv) Distribute resulting documents in accordance with [42.706](#).

(v) Notify the contractor of the individual costs which were considered unallowable and the respective amounts of the disallowance.

42.705-2 Auditor determination procedure.

(a) *Applicability and responsibility.* (1) The cognizant Government auditor shall establish final indirect cost rates for business units not covered in [42.705-1\(a\)](#).

(2) In addition, auditor determination may be used for business units that are covered in [42.705-1\(a\)](#) when the contracting officer (or cognizant Federal agency official) and auditor agree that the indirect costs can be settled with little difficulty and any of the following circumstances apply:

(i) The business unit has primarily fixed-price contracts, with only minor involvement in cost-reimbursement contracts.

(ii) The administrative cost of contracting officer determination would exceed the expected benefits.

(iii) The business unit does not have a history of disputes and there are few cost problems.

(iv) The contracting officer (or cognizant Federal agency official) and auditor agree that special circumstances require auditor determination.

(b) *Procedures.* (1) The contractor shall submit to the cognizant contracting officer (or cognizant Federal agency official) and auditor a final indirect cost rate proposal in accordance with [42.705-1\(b\)\(1\)](#).

(2) Upon receipt of a proposal, the auditor shall—

(i) Audit the proposal and seek agreement on indirect costs with the contractor;

(ii) Prepare an indirect cost rate agreement conforming to the requirements of the contracts. The agreement shall be signed by the contractor and the auditor;

(iii) If agreement with the contractor is not reached, forward the audit report to the contracting officer (or cognizant Federal agency official) identified in the Directory of Contract Administration Services Components (see [42.203](#)), who will then resolve the disagreement; and

(iv) Distribute resulting documents in accordance with [42.706](#).

42.705-3 Educational institutions.

(a) *General.* (1) Postdetermined final indirect cost rates shall be used in the settlement of indirect costs for all cost-reimbursement contracts with educational institutions, unless predetermined final indirect cost rates are authorized and used (see paragraph (b) of this subsection).

(2) OMB Circular No. A-21, Cost Principles for Educational Institutions, assigns each educational institution to a single Government agency for the negotiation of indirect cost rates and provides that those rates shall be accepted by all Federal agencies. Cognizant Government agencies and educational institutions are listed in the Directory of Federal Contract Audit Offices (see [42.103](#)).

(3) The cognizant agency shall establish the billing rates and final indirect cost rates at the educational institution, consistent with the requirements of this subpart, [Subpart 31.3](#), and the OMB Circular. The agency shall follow the procedures outlined in [42.705-1\(b\)](#).

(4) If the cognizant agency is unable to reach agreement with an institution, the appeals system of the cognizant agency shall be followed for resolution of the dispute.

(b) *Predetermined final indirect cost rates.* (1) Under cost-reimbursement research and development contracts with universities, colleges, or other educational institutions ([41 U.S.C. 254a](#)), payment for reimbursable indirect costs may be made on the basis of predetermined final indirect cost rates. The cognizant agency is not required to establish predetermined rates, but if they are established, their use must be extended to all the institution's Government contracts.

(2) In deciding whether the use of predetermined rates would be appropriate for the educational institution concerned, the agency should consider both the stability of the institution's indirect costs and bases over a period of years and any anticipated changes in the amount of the direct and indirect costs.

(3) Unless their use is approved at a level in the agency (see paragraph (a)(2) of this subsection) higher than the contracting officer, predetermined rates shall not be used when—

(i) There has been no recent audit of the indirect costs;

(ii) There have been frequent or wide fluctuations in the indirect cost rates and the bases over a period of years; or

(iii) The estimated reimbursable costs for any individual contract are expected to exceed \$1 million annually.

(4)(i) If predetermined rates are to be used and no rates have been previously established for the institution's current fiscal year, the agency shall obtain from the institution a proposal for predetermined rates.

(ii) If the proposal is found to be generally acceptable, the agency shall negotiate the predetermined rates with

the institution. The rates should be based on an audit of the institution's costs for the year immediately preceding the year in which the rates are being negotiated. If this is not possible, an earlier audit may be used, but appropriate steps should be taken to identify and evaluate significant variations in costs incurred or in bases used that may have a bearing on the reasonableness of the proposed rates. However, in the case of smaller contracts (*i.e.*, contracts that do not exceed the simplified acquisition threshold), an audit made at an earlier date is acceptable if—

(A) There have been no significant changes in the contractor's organization; and

(B) It is reasonably apparent that another audit would have little effect on the rates finally agreed upon and the potential for overpayment of indirect cost is relatively insignificant.

(5) If predetermined rates are used—

(i) The contracting officer shall include the negotiated rates and bases in the contract Schedule; and

(ii) See [16.307\(g\)](#), which prescribes the clause at [52.216-15](#), Predetermined Indirect Cost Rates.

(6) Predetermined indirect cost rates shall be applicable for a period of not more than four years. The agency shall obtain the contractor's proposal for new predetermined rates sufficiently in advance so that the new rates, based on current data, may be promptly negotiated near the beginning of the new fiscal year or other period agreed to by the parties (see paragraphs (b) and (d) of the clause at [52.216-15](#), Predetermined Indirect Cost Rates).

(7) Contracting officers shall use billing rates established by the agency to reimburse the contractor for work performed during a period not covered by predetermined rates.

42.705-4 State and local governments.

OMB Circular No. A-87 concerning cost principles for state and local governments (see [Subpart 31.6](#)) establishes the cognizant agency concept and procedures for determining a cognizant agency for approving state and local government indirect costs associated with federally-funded programs and activities. The indirect cost rates negotiated by the cognizant agency will be used by all Federal agencies that also award contracts to these same state and local governments.

42.705-5 Nonprofit organizations other than educational and state and local governments.

(See OMB Circular No. A-122.)

42.706 Distribution of documents.

(a) The contracting officer or auditor shall promptly distribute executed copies of the indirect cost rate agreement to the contractor and to each affected contracting agency and shall provide copies of the agreement for the contract files, in

accordance with the guidance for contract modifications in [Subpart 4.2](#), Contract Distribution.

(b) Copies of the negotiation memorandum prepared under contracting officer determination or audit report prepared under auditor determination shall be furnished, as appropriate, to the contracting offices and Government audit offices.

42.707 Cost-sharing rates and limitations on indirect cost rates.

(a) Cost-sharing arrangements, when authorized, may call for the contractor to participate in the costs of the contract by accepting indirect cost rates lower than the anticipated actual rates. In such cases, a negotiated indirect cost rate ceiling may be incorporated into the contract for prospective application. For cost sharing under research and development contracts, see [35.003\(b\)](#).

(b)(1) Other situations may make it prudent to provide a final indirect cost rate ceiling in a contract. Examples of such circumstances are when the proposed contractor—

(i) Is a new or recently reorganized company, and there is no past or recent record of incurred indirect costs;

(ii) Has a recent record of a rapidly increasing indirect cost rate due to a declining volume of sales without a commensurate decline in indirect expenses; or

(iii) Seeks to enhance its competitive position in a particular circumstance by basing its proposal on indirect cost rates lower than those that may reasonably be expected to occur during contract performance, thereby causing a cost overrun.

(2) In such cases, an equitable ceiling covering the final indirect cost rates may be negotiated and specified in the contract.

(c) When ceiling provisions are utilized, the contract shall also provide that—

(1) The Government will not be obligated to pay any additional amount should the final indirect cost rates exceed the negotiated ceiling rates, and

(2) In the event the final indirect cost rates are less than the negotiated ceiling rates, the negotiated rates will be reduced to conform with the lower rates.

42.708 Quick-closeout procedure.

(a) The contracting officer responsible for contract closeout shall negotiate the settlement of indirect costs for a specific contract, in advance of the determination of final indirect cost rates, if—

(1) The contract is physically complete;

(2) The amount of unsettled indirect cost to be allocated to the contract is relatively insignificant. Indirect cost amounts will be considered insignificant when—

(i) The total unsettled indirect cost to be allocated to any one contract does not exceed \$1,000,000; and

(ii) Unless otherwise provided in agency procedures, the cumulative unsettled indirect costs to be allocated to one or more contracts in a single fiscal year do not exceed 15 percent of the estimated, total unsettled indirect costs allocable to cost-type contracts for that fiscal year. The contracting officer may waive the 15 percent restriction based upon a risk assessment that considers the contractor's accounting, estimating, and purchasing systems; other concerns of the cognizant contract auditors; and any other pertinent information; and

(3) Agreement can be reached on a reasonable estimate of allocable dollars.

(b) Determinations of final indirect costs under the quick-closeout procedure provided for by the Allowable Cost and Payment clause at [52.216-7](#) shall be final for the contract it covers and no adjustment shall be made to other contracts for over- or under-recoveries of costs allocated or allocable to the contract covered by the agreement.

(c) Indirect cost rates used in the quick closeout of a contract shall not be considered a binding precedent when establishing the final indirect cost rates for other contracts.

42.709 Scope.

(a) This section implements [10 U.S.C. 2324\(a\)](#) through (d) and [41 U.S.C. 256\(a\)](#) through (d). It covers the assessment of penalties against contractors which include unallowable indirect costs in—

(1) Final indirect cost rate proposals; or

(2) The final statement of costs incurred or estimated to be incurred under a fixed-price incentive contract.

(b) This section applies to all contracts in excess of \$650,000, except fixed-price contracts without cost incentives or any firm-fixed-price contracts for the purchase of commercial items.

42.709-1 General.

(a) The following penalties apply to contracts covered by this section:

(1) If the indirect cost is expressly unallowable under a cost principle in the FAR, or an executive agency supplement to the FAR, that defines the allowability of specific selected costs, the penalty is equal to—

(i) The amount of the disallowed costs allocated to contracts that are subject to this section for which an indirect cost proposal has been submitted; plus

(ii) Interest on the paid portion, if any, of the disallowance.

(2) If the indirect cost was determined to be unallowable for that contractor before proposal submission, the penalty is two times the amount in paragraph (a)(1)(i) of this section.

(b) These penalties are in addition to other administrative, civil, and criminal penalties provided by law.

(c) It is not necessary for unallowable costs to have been paid to the contractor in order to assess a penalty.

42.709-2 Responsibilities.

- (a) The cognizant contracting officer is responsible for—
- (1) Determining whether the penalties in [42.709-1\(a\)](#) should be assessed;
 - (2) Determining whether such penalties should be waived pursuant to [42.709-5](#); and
 - (3) Referring the matter to the appropriate criminal investigative organization for review and for appropriate coordination of remedies, if there is evidence that the contractor knowingly submitted unallowable costs.
- (b) The contract auditor, in the review and/or the determination of final indirect cost proposals for contracts subject to this section, is responsible for—
- (1) Recommending to the contracting officer which costs may be unallowable and subject to the penalties in [42.709-1\(a\)](#);
 - (2) Providing rationale and supporting documentation for any recommendation; and
 - (3) Referring the matter to the appropriate criminal investigative organization for review and for appropriate coordination of remedies, if there is evidence that the contractor knowingly submitted unallowable costs.

42.709-3 Assessing the penalty.

Unless a waiver is granted pursuant to [42.709-5](#), the cognizant contracting officer shall—

- (a) Assess the penalty in [42.709-1\(a\)\(1\)](#), when the submitted cost is expressly unallowable under a cost principle in the FAR or an executive agency supplement that defines the allowability of specific selected costs; or
- (b) Assess the penalty in [42.709-1\(a\)\(2\)](#), when the submitted cost was determined to be unallowable for that contractor prior to submission of the proposal. Prior determinations of unallowability may be evidenced by—
 - (1) A DCAA Form 1, Notice of Contract Costs Suspended and/or Disapproved (see 48 CFR 242.705-2), or any similar notice which the contractor elected not to appeal and was not withdrawn by the cognizant Government agency;
 - (2) A contracting officer final decision which was not appealed;
 - (3) A prior executive agency Board of Contract Appeals or court decision involving the contractor, which upheld the cost disallowance; or
 - (4) A determination or agreement of unallowability under [31.201-6](#).
- (c) Issue a final decision (see [33.211](#)) which includes a demand for payment of any penalty assessed under paragraph (a) or (b) of this section. The letter shall state that the determination is a final decision under the Disputes clause of the contract. (Demanding payment of the penalty is sepa-

rate from demanding repayment of any paid portion of the disallowed cost.)

42.709-4 Computing interest.

For [42.709-1\(a\)\(1\)\(ii\)](#), compute interest on any paid portion of the disallowed cost as follows:

- (a) Consider the overpayment to have occurred, and interest to have begun accumulating, from the midpoint of the contractor's fiscal year. Use an alternate equitable method if the cost was not paid evenly over the fiscal year.
- (b) Use the interest rate specified by the Secretary of the Treasury pursuant to Pub. L. 92-41 (85 Stat. 97).
- (c) Compute interest from the date of overpayment to the date of the demand letter for payment of the penalty.
- (d) Determine the paid portion of the disallowed costs in consultation with the contract auditor.

42.709-5 Waiver of the penalty.

The cognizant contracting officer shall waive the penalties at [42.709-1\(a\)](#) when—

- (a) The contractor withdraws the proposal before the Government formally initiates an audit of the proposal and the contractor submits a revised proposal (an audit will be deemed to be formally initiated when the Government provides the contractor with written notice, or holds an entrance conference, indicating that audit work on a specific final indirect cost proposal has begun);
- (b) The amount of the unallowable costs under the proposal which are subject to the penalty is \$10,000 or less (*i.e.*, if the amount of expressly or previously determined unallowable costs which would be allocated to the contracts specified in [42.709\(b\)](#) is \$10,000 or less); or
- (c) The contractor demonstrates, to the cognizant contracting officer's satisfaction, that—
 - (1) It has established policies and personnel training and an internal control and review system that provide assurance that unallowable costs subject to penalties are precluded from being included in the contractor's final indirect cost rate proposals (*e.g.*, the types of controls required for satisfactory participation in the Department of Defense sponsored self-governance programs, specific accounting controls over indirect costs, compliance tests which demonstrate that the controls are effective, and Government audits which have not disclosed recurring instances of expressly unallowable costs); and
 - (2) The unallowable costs subject to the penalty were inadvertently incorporated into the proposal; *i.e.*, their inclusion resulted from an unintentional error, notwithstanding the exercise of due care.

42.709-6 Contract clause.

Use the clause at [52.242-3](#), Penalties for Unallowable Costs, in all solicitations and contracts over \$650,000 except

fixed-price contracts without cost incentives or any firm-fixed-price contract for the purchase of commercial items. Generally, covered contracts are those which contain one of

the clauses at [52.216-7](#), [52.216-16](#), or [52.216-17](#), or a similar clause from an executive agency's supplement to the FAR.

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Subpart 42.8—Disallowance of Costs

42.800 Scope of subpart.

This subpart prescribes policies and procedures for—

- (a) Issuing notices of intent to disallow costs; and
- (b) Disallowing costs already incurred during the course of performance.

42.801 Notice of intent to disallow costs.

(a) At any time during the performance of a contract of a type referred to in [42.802](#), the cognizant contracting officer responsible for administering the contract may issue the contractor a written notice of intent to disallow specified costs incurred or planned for incurrence. However, before issuing the notice, the contracting officer responsible for administering the contract shall make every reasonable effort to reach a satisfactory settlement through discussions with the contractor.

(b) A notice of intent to disallow such costs usually results from monitoring contractor costs. The purpose of the notice is to notify the contractor as early as practicable during contract performance that the cost is considered unallowable under the contract terms and to provide for timely resolution of any resulting disagreement. In the event of disagreement, the contractor may submit to the contracting officer a written response. Any such response shall be answered by withdrawal of the notice or by making a written decision within 60 days.

(c) As a minimum, the notice shall—

- (1) Refer to the contract's Notice of Intent to Disallow Costs clause;
- (2) State the contractor's name and list the numbers of the affected contracts;
- (3) Describe the costs to be disallowed, including estimated dollar value by item and applicable time periods, and state the reasons for the intended disallowance;
- (4) Describe the potential impact on billing rates and forward pricing rate agreements;
- (5) State the notice's effective date and the date by which written response must be received;
- (6) List the recipients of copies of the notice; and
- (7) Request the contractor to acknowledge receipt of the notice.

(d) The contracting officer issuing the notice shall furnish copies to all contracting officers cognizant of any segment of the contractor's organization.

(e) If the notice involves elements of indirect cost, it shall not be issued without coordination with the contracting officer or auditor having authority for final indirect cost settlement (see [42.705](#)).

(f) In the event the contractor submits a response that disagrees with the notice (see paragraph (b) of this section), the

contracting officer who issued the notice shall either withdraw the notice or issue the written decision, except when elements of indirect cost are involved, in which case the contracting officer responsible under [42.705](#) for determining final indirect cost rates shall issue the decision.

42.802 Contract clause.

The contracting officer shall insert the clause at [52.242-1](#), Notice of Intent to Disallow Costs, in solicitations and contracts when a cost-reimbursement contract, a fixed-price incentive contract, or a contract providing for price redetermination is contemplated.

42.803 Disallowing costs after incurrence.

Cost-reimbursement contracts, the cost-reimbursement portion of fixed-price contracts, letter contracts that provide for reimbursement of costs, and time-and-material and labor-hour contracts provide for disallowing costs during the course of performance after the costs have been incurred. The following procedures shall apply:

(a) *Contracting officer receipt of vouchers.* When contracting officers receive vouchers directly from the contractor and, with or without auditor assistance, approve or disapprove them, the process shall be conducted in accordance with the normal procedures of the individual agency.

(b) *Auditor receipt of vouchers.* (1) When authorized by agency regulations, the contract auditor may be authorized to (i) receive reimbursement vouchers directly from contractors, (ii) approve for payment those vouchers found acceptable, and (iii) suspend payment of questionable costs. The auditor shall forward approved vouchers for payment to the cognizant contracting, finance, or disbursing officer, as appropriate under the agency's procedures.

(2) If the examination of a voucher raises a question regarding the allowability of a cost under the contract terms, the auditor, after informal discussion as appropriate, may, where authorized by agency regulations, issue a notice of contract costs suspended and/or disapproved simultaneously to the contractor and the disbursing officer, with a copy to the cognizant contracting officer, for deduction from current payments with respect to costs claimed but not considered reimbursable.

(3) If the contractor disagrees with the deduction from current payments, the contractor may—

(i) Submit a written request to the cognizant contracting officer to consider whether the unreimbursed costs should be paid and to discuss the findings with the contractor;

(ii) File a claim under the Disputes clause, which the cognizant contracting officer will process in accordance with agency procedures; or

(iii) Do both of the above.