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The Cost Corner

Government Contracts Cost and Pricing: Penalties for Unallowable Costs

*By Keith Szeliga and Lillia Damalouji**

Welcome back to the Cost Corner, where we provide practical insight into the complex cost and pricing requirements that apply to government contractors. This is the fourth column in a multi-part series on the Federal Acquisition Regulation (FAR) Cost Principles applicable to contracts with commercial organizations. The last column addressed accounting for unallowable costs. This Cost Corner focuses on penalties for unallowable costs. The relevant FAR provisions are FAR 42.709 and FAR 52.242-3, both entitled "Penalties for Unallowable Costs." This column begins with an overview of the penalty provisions. It then address the interpretation of expressly unallowable costs and the penalty waiver provisions.

BASIC CONCEPTS

The Federal Acquisition Regulation (FAR) implements statutory penalties against contractors that include unallowable indirect costs in final indirect cost rate proposals and the final statement of costs incurred or estimated to be incurred under a fixed-price incentive (FPI) contract.¹ The penalty provisions apply to all contracts over \$800,000, excluding fixed-price contracts without cost incentives and firm-fixed-price contracts for commercial products or commercial services.²

There are two levels of penalties. A Level 1 penalty is assessed when the indirect cost is expressly unallowable under a cost principle in the FAR or an agency supplement.³

The Level 1 penalty is equal to the amount of the disallowed costs allocated to contracts subject to the clause for which the indirect cost proposal has been submitted plus interest on any paid portion of the disallowance.⁴

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¹ FAR 42.709-1(a); see, also, 10 U.S.C. § 3743; 41 U.S.C. § 4303.

² FAR 42.709-1(b).

³ FAR 42.709-2(a)(1).

⁴ Id.

A Level 2 penalty is assessed when the indirect cost was determined to be unallowable for that contractor before indirect cost rate proposal submission.⁵ The Level 2 penalty is twice the amount of the disallowed costs allocated to contracts subject to the clause.⁶ These penalties are in addition to the disallowance of the cost and any other administrative, civil, and criminal penalties that may be assessed.⁷ Moreover, it is not necessary for unallowable costs to have been paid to the contractor in order to assess a penalty; the penalty provision is triggered simply by including the unallowable costs in the indirect cost proposal.⁸

Interest is calculated on any paid portion of the disallowed cost as follows:

- (1) Considering the overpayment to have occurred and interest to have begun accumulating from the midpoint of the contractor's fiscal year (or an otherwise equitable method if the cost was not paid evenly over the fiscal year);
- (2) Using the interest rate specified by the Secretary of Treasury;
- (3) Computing interest from the date of overpayment to the date of the payment demand letter; and
- (4) Determining the paid portion of the disallowed costs with the contract auditor.⁹

The cognizant contracting officer is responsible for determining whether the penalties should be assessed, determining whether the penalties should be waived, and referring the matter to the appropriate criminal investigative organization if there is evidence that the contractor knowingly submitted unallowable costs.¹⁰ The contract auditor is responsible for recommending to the contracting officer which costs may be unallowable and subject to the penalties, for providing rationale and supporting documentation for any recommendation, and also for referring matters to criminal investigative organizations, as appropriate.¹¹

Unless a waiver is granted, the FAR directs the contracting officer to assess a Level 1 penalty when the submitted cost is expressly unallowable under a cost

⁵ FAR 42.709-2(a)(2).

⁶ Id.

⁷ FAR 42.709-2(b).

⁸ FAR 42.709-2(c).

⁹ FAR 42.709-5.

¹⁰ FAR 42.709-3(a).

¹¹ FAR 42.709-3(b).

principle in the FAR or an agency supplement that defines the allowability of specific select costs.¹² Similarly, unless a waiver is granted, the FAR directs the contracting officer to assess a Level 2 penalty when the submitted cost was determined to be unallowable for the contractor prior to submission of the indirect cost rate proposal.¹³

The FAR provides that prior determinations of unallowability may be evidenced by:

- (1) A Defense Contract Audit Agency (DCAA) Form 1, Notice of Contract Costs Suspended and/or Disapproved, or any similar notice that has not been appealed or withdrawn;
- (2) A contracting officer's final decision that has not been appealed;
- (3) A prior decision involving the contractor in which a Board of Contract Appeals or court decision upheld disallowance of the cost; or
- (4) A determination or agreement of unallowability under FAR 31.201-6.¹⁴

The FAR further directs the contracting officer to issue a final decision that includes a demand for payment of the penalty.¹⁵

The FAR implements penalties for unallowable costs for contractors in the clause found at FAR 52.243-3, Penalties for Unallowable Costs.¹⁶ The clause is mandatory for all contracts over \$800,000, except fixed-price contracts without cost incentives and firm-fixed-price contracts for commercial products or commercial services.

EXPRESSLY UNALLOWABLE COSTS

The FAR defines an “expressly unallowable cost” as a “particular item or type of cost which, under the express provisions of an applicable law, regulation, or contract, is specifically named and stated to be unallowable.”¹⁷ However, penalties are limited to indirect costs that are expressly unallowable “under a cost principle in the FAR,” or applicable agency supplement, “that defines the

¹² FAR 42.709-4(a).

¹³ FAR 42.709-4(b).

¹⁴ *Id.*

¹⁵ FAR 42.709-4(c).

¹⁶ FAR 42.709-7.

¹⁷ FAR 31.001.

allowability of specific selected costs.”¹⁸ This excludes costs determined to be unallowable solely because they are unreasonable, unallocable, non-compliant with the Cost Accounting Standards (CAS) or Generally Accepted Accounting Principles (GAAP), or made unallowable by a contract provision.¹⁹

The Armed Services Board of Contract Appeals (ASBCA) has explained that a cost is “expressly unallowable” only if there cannot be reasonable differences of opinion regarding the allowability of that cost:

We think Congress intended the standard to be an objective one. The FAR and CAS definitions of “expressly unallowable” point to the need to examine the particular principle involved in light of the surrounding circumstances. Moreover, since Congress adopted the “expressly unallowable” standard to make it clear that a penalty should not be assessed where there were reasonable differences of opinion about the allowability of costs, we think the Government must show that it was unreasonable under all the circumstances for a person in the contractor’s position to conclude that the costs were allowable. The scope of the inquiry will vary with the clarity and complexity of the particular cost principle and the circumstances involved.²⁰

More recently, the U.S. Court of Appeals for the Federal Circuit determined that salary costs for employees engaging in lobbying activities were expressly unallowable even though the relevant cost principle addressed the allowability of costs “associated with” lobbying activities without expressly naming and stating salaries for personnel engaged in such activities to be unallowable.²¹ The Federal Circuit reasoned that “[c]osts unambiguously falling within a generic description of a ‘type’ of unallowable cost are also ‘expressly unallowable.’”²² This conclusion seems inconsistent with the definition of “expressly unallowable costs” as costs “specifically named and stated to be unallowable” but, at least arguably, it does not disturb the general principle that penalties are

¹⁸ FAR 42.709-2(a)(1).

¹⁹ Raytheon Co., ASBCA No. 57743, 17-1 BCA ¶ 36,724; see, also, Defense Contract Audit Agency (DCAA), Contract Audit Manual (DCAM), ¶ 6-609.1.c.1 (“It does not include any costs that are unallowable because they violate any other regulatory requirement or contract term, unless such regulation or contract term is also included in the cost principles. Therefore, there could be situations where a cost may be expressly unallowable but not subject to penalties.”).

²⁰ General Dynamics Corp., ASBCA No. 49372, 02-2 BCA ¶ 31888, rev’d in part by *Rumsfeld v. General Dynamics Corp.*, 365 F.3d 1380 (Fed. Cir. 2004).

²¹ *Raytheon Co. v. Sec’y of Def.*, 940 F.3d 1310 (Fed. Cir. 2019).

²² *Id.* at 1313.

appropriate only where there can be no “reasonable differences of opinion” about allowability.

The DCAA has adopted the ASBCA guidance quoted above in its definition of expressly unallowable costs.²³ In applying that guidance, however, the DCAA has prepared, as a “tool” for its auditors, a Listing of Cost Principles Identifying Expressly Unallowable Costs. The Listing identifies no less than ninety-one categories of costs that DCAA considers to be “expressly unallowable” pursuant to the FAR and DFARS Cost Principles.²⁴ The DCAM advises audit teams that, if they question a cost included in the Listing, they “generally should treat the questioned cost as expressly unallowable and subject to penalties.”²⁵ If nothing else, the Listing provides a valuable checklist of the types of costs contractors can expect DCAA to question as expressly unallowable costs.

WAIVER OF PENALTIES

The FAR provides that the contracting officer “shall waive the penalties” under three circumstances.²⁶ Waiver of the penalties is mandatory when those circumstances apply.²⁷

First, the contracting officer must waive the penalties if the contractor withdraws the indirect cost rate proposal before the government formally initiates an audit and the contractor submits a revised proposal.²⁸ An audit is 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.²⁹

Second, the contracting officer must waive the penalties if the amount of unallowable cost under the proposal that is subject to the penalty is \$10,000 or less, i.e., if the amount of expressly or previously determined unallowable costs that would be allocated to the covered contracts is \$10,000 or less.³⁰ The

²³ DCAA, DCAM ¶ 6-609.1.c.1 (“In order for a cost to be expressly unallowable, the cost principle must state in direct terms that the costs are unallowable, or leaves little room for interpretation or differences of opinion as to whether the particular cost meets the allowability criteria. The government must show that it was unreasonable, under all the circumstances, for a person in the contractor’s position to conclude that the costs were allowable.”).

²⁴ DCAA, DCAM, Appendix A, A-100, Figure A-1-1 (Jan. 2021).

²⁵ DCAA, DCAM, Appendix A, A-102.1.

²⁶ FAR 42.709-6.

²⁷ See FAR 2.1.1 (“ ‘shall’ denotes the imperative”).

²⁸ FAR 42.709-6(a).

²⁹ *Id.*

³⁰ FAR 42.709-6(b).

ASBCA has held that the \$10,000 limitation applies to the cumulative amount of the expressly unallowable costs rather than each rather than each category of costs determined to be expressly unallowable.³¹

Third, the contracting officer must waive the penalties if the contractor demonstrates, to the contracting officer's satisfaction, that: (1) it has established policies and personnel training and an internal control and review system that provide assurances that unallowable costs subject to penalties are precluded from being included in the contractor's final indirect cost rate proposals, 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.³² With regard to the first requirement, the FAR identifies, as examples, 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 that demonstrate that the controls are effective, and government audits that have not disclosed recurring instances of expressly unallowable costs.³³ To qualify for the waiver, the necessary policies and internal controls must have been in place at the time the contractor submitted its indirect cost rate proposal rather than implemented later.³⁴

CONCLUSION

This column has addressed penalties for expressly unallowable costs. The next edition of the Cost Corner will address compensation for personal services.

³¹ See *Exelis, Inc.*, ASBCA No. 58966, 17-1 BCA ¶ 36,708.

³² FAR 42.709-6(c).

³³ FAR 42.709-6(c)(1).

³⁴ See *Energy Matter Conversion Corp.*, ASBCA No. 61583, 19-1 BCA ¶ 37,225.