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The Cost Corner

Government Contracts Cost and Pricing: Accounting 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 third column in a multi-part series on the Federal Acquisition Regulation (FAR) Cost Principles applicable to contracts with commercial organizations. The first column in the series addressed the criteria for determining the allowability of costs. The second addressed the allocation of direct and indirect costs. This Cost Corner focuses accounting for unallowable costs. The applicable Cost Principle is FAR 31.201-6, Accounting for Unallowable Costs. Among other requirements, FAR 31.201-6 incorporates by reference the practices for accounting for, and presentation of, unallowable costs provided in Cost Accounting Standard (CAS) 405, also titled Accounting for Unallowable Costs. This column addresses both the FAR and the CAS requirements.

IDENTIFICATION OF UNALLOWABLE COSTS

The Federal Acquisition Regulation (FAR) Cost Principles and Cost Accounting Standard (CAS) 405 include similar requirements for expressly unallowable costs and mutually agreed to be unallowable costs.¹ Both require a contractor to identify such costs and exclude them from any billing, claim, or proposal applicable to a government contract.²

An “expressly unallowable cost” is an item or type of cost specifically named and stated to be unallowable by the express provisions of an applicable law, regulation, or contract clause.³ A cost is expressly unallowable if it is unreasonable under all the circumstances for a person in the contractor’s position to conclude that the cost is allowable.⁴ A cost is not expressly unallowable if there is room for interpretation or differences of opinion

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¹ FAR 31.201-6(a); CAS 405-40(a).

² FAR 31.201-6(a); CAS 405-40(a).

³ FAR 31.001; CAS 405-30(a)(3).

⁴ General Dynamics Corp., ASBCA No. 49372, 02-2 BCA ¶ 31,888.

regarding whether the costs meets the allowability criteria.⁵ We will address expressly unallowable costs, including penalties, in further detail in the next Cost Corner.

A “mutually agreed to be unallowable cost” is a cost specifically designated as unallowable under an agreement between the government and the contractor.⁶ The agreement should be written and describe the costs in sufficient detail to conclusively identify the costs in future proposals or claims.⁷ A contractor’s agreement or concession not to bill for a cost or to reduce its indirect rate in a settlement process does not result in a mutually agreed to be unallowable cost unless the parties enter into an agreement specifically identifying the costs as unallowable.⁸ Mutually agreed to be unallowable costs include mutually agreed to be unallowable directly associated costs, which are explained in the next section of this column.⁹

If costs specifically become designated as unallowable or as unallowable directly associated costs as the result of a contracting officer’s written decision, the FAR and the CAS permit a contractor to include those costs in billings, claims, or proposals applicable to government contracts—but the contractor must specifically identify those costs.¹⁰ The same identification requirement applies to any costs incurred for the same purpose under like circumstances as expressly unallowable costs and mutually agreed to be unallowable costs.¹¹

The FAR and the CAS do not prescribe any particular method for identifying the categories of unallowable costs addressed above. CAS 405 indicates that a contractor may satisfy the identification requirement by “any form of cost identification which is adequate for purpose of contract cost determination and verification.”¹² It identifies several acceptable practices for identifying unallowable incurred and estimated costs but does not prohibit other approaches.¹³

⁵ Defense Contract Audit Agency (DCAA), Contract Audit Manual (DCAM), ¶ 6-609.1.a.c.1.

⁶ DCAM, ¶ 6-609.1.a.c.3.

⁷ DCAM, ¶ 6-609.1.a.c.3.

⁸ DCAM, ¶ 6-609.1.a.c.3.

⁹ FAR 31.201-6(a); CAS 405-50(a).

¹⁰ FAR 31.201-6(b); CAS 405-40(b)–(c).

¹¹ FAR 31.201-6(b); CAS 405-40(b).

¹² CAS 405-50(b)(1).

¹³ CAS 405-50(b).

UNALLOWABLE DIRECTLY ASSOCIATED COSTS

The FAR and the CAS also provide for similar treatment of unallowable directly associated costs. A “directly associated cost” is any cost generated solely as the result of incurring another cost, and that would not have been incurred had the contractor not incurred the other cost.¹⁴ For example entertainment costs, such as the costs of tickets to shows, are unallowable.¹⁵ Costs incurred in traveling to a show are directly associated costs because they would not be incurred but for the show, which is an unallowable cost.

When a contractor incurs an unallowable cost, its directly associated costs are also unallowable—but only if they are material in amount or their allowance would be contrary to public policy.¹⁶ The FAR identifies three factors relevant to determining the materiality of directly associated costs:

- (1) The actual dollar amount;
- (2) The cumulative effect of all directly associated costs in a cost pool; and
- (3) The ultimate effect on the cost of government contracts.¹⁷

The salary expense associated with an employee’s time spent on activities that generate unallowable costs is an unallowable directly associated cost if the time spent on that activity is material in comparison to the total time the employee spends on company activities.¹⁸ A contractor should exclude time outside normal working hours from the materiality analysis unless activities during periods outside normal working hours are part of an employee’s regular job responsibilities.¹⁹

ALLOCATION OF UNALLOWABLE INDIRECT COSTS

The same allocability principles apply to both allowable and unallowable costs.²⁰ If an indirect cost is expressly unallowable or mutually agreed to be unallowable, the contractor must exclude the cost from billings, claims, and

¹⁴ FAR 31.201-6(a); CAS 405-30(a)(1).

¹⁵ FAR 31.205-14.

¹⁶ FAR 31.201-6(a), (e)(3).

¹⁷ FAR 31.201-6(e)(1).

¹⁸ FAR 31.201-6(e)(2); see also *Raytheon Co. v. Sec’y of Def.*, 940 F.3d 1310 (Fed. Cir. 2019).

¹⁹ FAR 31.201-6(e)(2).

²⁰ CAS 405-40(e).

proposals by removing it from the appropriate indirect cost pool.²¹ However, the contractor must retain the unallowable cost in the allocation base so that it absorbs a proportionate share of the contractor's otherwise allowable indirect costs.²²

A different analysis applies to unallowable directly associated costs. If a directly associated cost is part of a category of costs normally included in an indirect cost pool allocated over a base that also contains the directly associated cost, a contractor must retain the cost in both the pool and the base.²³ Since the unallowable directly associated cost in the base will absorb an allocable share of unallowable directly associated costs from the pool, removing the cost from the base is unnecessary and would result in a double disallowance.²⁴

If, on the other hand, a contractor normally would allocate an unallowable directly associated cost over a base that does not include that unallowable directly associated cost, the contractor must remove the cost from the pool and retain it in the base, provided the amount of the cost is material.²⁵

STATISTICAL SAMPLING

The FAR permits a contractor to use statistical sampling to identify unallowable costs subject to the following criteria:

- (1) The statistical sample must result in an "unbiased sample" that is a reasonable representation of the sample universe;
- (2) The contractor must separately review "large dollar value or high risk" transactions for unallowable costs and exclude them from the sampling process; and
- (3) The statistical sample must be verifiable in an audit.²⁶

The FAR recommends but does not require an advance agreement to specify the basic characteristics of the sampling process.²⁷ If there is no advance agreement and the government challenges a contractor's statistical sampling

²¹ FAR 31.201-6(d).

²² CAS 405-40(e).

²³ FAR 31.201-6(d); CAS 405-40(e).

²⁴ FAR 31.201-6(d).

²⁵ FAR 31.201-6(d).

²⁶ FAR 31.201-6(c)(2).

²⁷ FAR 31.201-6(c)(4).

methods, the contractor has the burden to prove that the sampling methods satisfies the above criteria.²⁸

CONCLUSION

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

²⁸ FAR 31.201-6(c)(5).

