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Miller & Chevalier

GovCon 101 – Allowable and Unallowable Costs

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What are “Allowable Costs”? (FAR 31.201-2)

- Cost-reimbursement contracts allow for payment of “allowable incurred costs.” FAR 16.301-1.
- **Determining allowability (FAR 31.201-2):** To be allowable, a cost must comply with all of the following requirements:
 1. Reasonableness;
 2. Allocability;
 3. The Cost Accounting Standards, if applicable, generally accepted accounting principles, and practices appropriate to the circumstances;
 4. Terms of the contract;
 5. Limitations set forth in FAR subpart 31.2.

What is a “Reasonable” Cost? (FAR 31.201-3)

- A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business.
- Considerations include:
 - General recognition as ordinary/necessary for the business or the contract performance
 - Generally accepted sound business practices, arm’s-length bargaining, and Federal and State laws and regulations
 - The contractor’s responsibilities to the Government, other customers, the business owners, employees, and the public at large
 - The contractor’s established practices
- No presumption of reasonableness.

Reasonableness – Cases

- *Kellogg Brown & Root Servs., Inc. v. United States*, 728 F.3d 1348, 1360–62 (Fed. Cir. 2013):
 - Holding that incurred costs may be found unreasonable even absent a showing that the contractor’s conduct rose to the level of “arbitrary action,” “gross negligence,” or “willful misconduct”;
 - Upholding disallowance of ~\$30 million of costs based on conclusion that prime contractor should have “seized any available advantage” and negotiated a lower REA amount with its subcontractor
- *Kellogg Brown & Root Servs., Inc. v. United States*, 742 F.3d 967, 971–72 (Fed. Cir. 2014):
 - Upholding disallowance of ~\$5.8 million of costs based on conclusion that prime contractor should have conducted further analysis of proposed price for subcontract modification and obtained additional information from subcontractor;
 - Reasonableness is ascertained based upon the circumstances existing at the time the costs were incurred
 - Leaving open whether costs that result from *mere negligence* may be allowable

What Is Allocability? (FAR 31.201-4)

- A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship.
- A cost is allocable to a Government contract if it-
 - Is incurred specifically for the contract;
 - Benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; or
 - Is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown.
- *Teknowledge Corp. v. United States*, 350 F. App'x 452, 455–56 (Fed. Cir. 2009):
 - Upholding disallowance of \$285,656 of costs for software development based on finding that the software was not sold to the government, was not connected to the products sold to the government, and was not otherwise necessary for the overall operation of the business;
 - Finding that, where benefits from a given cost to a government contract are remote and insubstantial, the cost is not allocable to the contract

Compliance with Contract Terms (FAR 31.201-2(a)(4))

- Costs that do not comply with the terms of the contract are generally not allowable .
 - *Bechtel Nat'l, Inc. v. United States*, 929 F.3d 1375 (July 16, 2019) (costs incurred to defend against discrimination suits, where contract terms prohibited discrimination, are unallowable unless contractor can show the suits had “very little likelihood of success”).
- A cost may be allowable, even if it is allegedly not compliant with the contract terms, where it was incurred as a result of the government’s prior material breach
 - *Sec'y of the Army v. Kellogg Brown & Root Servs., Inc.*, 779 F. App'x 716 (Fed. Cir. 2019) (upholding the allowability of security-related costs where the costs were incurred because the government materially breached its obligation to ensure contractor personnel’s safety).

Consistent With Cost Principles in FAR subpart 31.2

- The FAR cost principles are prescriptive requirements that define the allowability of selected items of cost (e.g., depreciation, labor relations, materials, recruitment, taxes, etc.).
- *A-T Solns., Inc.*, ASBCA No. 59338, 17-1 B.C.A. (CCH) ¶ 36655 (Feb. 8, 2017).
 - The Government bears the burden to prove that costs are not allowable if based on a FAR cost principle;
 - Contractor was entitled to payment for the price of materials (versus cost) under a cost-type contract based on FAR 31.205-26(e) which allows for material costs to be billed at price when costs are transferred and recorded between company segments at price

Materiality in Incurred Cost Audits

- Incurred Cost Proposal: Required annually for all cost-type contracts and includes a detailed report of incurred costs with supporting data. (FAR 52.216-7 “Allowable Cost & Payment Clause”).
 - Auditors use a “materiality” threshold to determine what costs to review—material balances are generally audited but a risk assessment will impact the nature, timing, and extent of the audit (and can justify an audit of non-material balances). CAM 6-107.
 - “Materiality”: misstatements, including omissions, individually or in the aggregate, that could reasonably be expected to influence relevant decisions of intended users. Includes both qualitative and quantitative factors. The weight given to the factors is subject to the auditor’s professional judgment. CAM 6-107.

Materiality in Incurred Cost Proposals

- A DCAA MRD adopts commercially accepted standards of determining materiality by implementing an equation for auditors to determine the quantitative materiality threshold. (MRD 19-PAS-003, July 19, 2019).

Total Audit Subject Matter*	
\$1—\$1,000,000,000	Materiality Threshold = $\$5,000 \times ((\text{Total Subject Matter} / \$100,000)^{.75})$
Greater than \$1,000,000,000	Materiality Threshold = 0.50 percent

*“Total audit subject matter” is the total information the auditor will provide an opinion on.

Materiality in Incurred Cost Proposals

Quantified Materiality Thresholds for Incurred Cost Audits

Subject Matter Cost	\$100K	\$1M	\$10M	\$100M	\$500M	\$1B
Materiality Amount	\$5,000	\$28,117	\$158,114	\$889,140	\$2,973,018	\$5,000,000
Materiality Percentage	5%	2.81%	1.58%	0.89%	0.59%	0.50%

Selected Costs – Compensation for personal services (FAR 31.205-6)

- “Compensation for personal services” broadly defined as “all remuneration paid currently or accrued, in whatever form and whether paid immediately or deferred, for services rendered by employees to the contractor during the period of contract performance” —is generally allowable if reasonable in amount for the work performed
- Bonuses and incentive compensation: allowable provided the awards are paid or accrued under an agreement entered into in good faith between the contractor and the employees before the services are rendered pursuant to an established plan or policy followed by the contractor consistently
- Severance pay: allowable only to the extent it is required by law, employer-employee agreement established policy, or circumstances of the particular employment
- Stock options and dividend payments: unallowable
- Pension costs: allowable dependent on numerous factors, including structure of the pension plan, reasonableness of amount, whether terms of plan discriminate against the government, and whether terms of plan are consistently applied to all employees under similar circumstances
 - Pension adjustments and asset reversions (FAR 31.205-6(j)(3))
- Statutory Limitation on Allowability of Compensation: for any contractor employee on/after June 24, 2014 is \$1,144,888 (81 FR 13833-01)

Selected Costs – Material costs (FAR 31.205-26)

- “Material costs” defined to include costs of such items as “raw materials, parts, subassemblies, components, and manufacturing supplies, whether purchased or manufactured by the contractor, and may include such collateral items as inbound transportation and in-transit insurance”
- The contractor shall-
 - Adjust the costs of material for income and other credits (including available trade discounts, refunds, rebates, allowances, cash discounts, and credits)
 - Credit such income and other credits either directly to the cost of the material or allocate such income and other credits as a credit to indirect costs. When the contractor can demonstrate that failure to take cash discounts was reasonable, the contractor does not need to credit lost discounts.
- Intracorporate Transfers
 - Allowance for all materials, supplies and services that are sold or transferred between any divisions, subdivisions, subsidiaries, or affiliates of the contractor under a common control shall be **on the basis of cost** incurred in accordance with this subpart.
 - However, allowance may be at price when-
 - It is the established practice of the transferring organization to price interorganizational transfers at other than cost for commercial work of the contractor or any division, subsidiary or affiliate of the contractor under a common control; and
 - The item being transferred qualifies for an exception under 15.403-1(b) and the contracting officer has not determined the price to be unreasonable.
 - When a commercial product or service is sold or transferred at a price based on catalog or market price, the contractor (1) should adjust the price to reflect quantities being acquired, and (2) may adjust the price to reflect the actual cost of any modifications necessary due to contract requirements

Expressly Unallowable Costs (FAR 31.001)

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.

- Expressly unallowable costs are subject to significant penalties if included in a final indirect cost rate proposal or final statement of costs. FAR 42.709-1(a).
- The cost principle must explicitly state disallowance (i.e., “Costs incident to major repair and overhaul of rental equipment are unallowable.”).
- DCAA auditor guidance removed 19 presumptions related to expressly unallowable costs that were based on cost principles that did not expressly prohibit the costs. See [DCAA MRD 19-PAC-002\(R\) \(May 14, 2019\)](#).
 - Nonetheless, 85 FAR clause provisions within Cost Principles that identify expressly unallowable costs, including:
 - Certain Public Relations and Advertising costs [FAR 31.205-1(f)]
 - Backpay [FAR 31.205-6(h)]
 - Certain Depreciation costs [FAR 31.205-11]
 - Gifts and Entertainment costs [31.205-13, 14]
 - Various Insurance costs [FAR 31.205-19]
 - Certain Organizational costs [FAR 31.205-27]
 - Various Lobbying and Political Activity costs [FAR 31.205-22]
 - Alcohol [FAR 31.205-51]

Expressly Unallowable Costs – *Raytheon*

Secretary of Defense v. Raytheon Company, Raytheon Missile Systems, No. 2021-2304 (Fed. Cir. Jan. 3, 2023)

- Costs associated with (1) attempts to influence outcomes of political elections, and (2) political parties, campaigns, or PACs are unallowable. FAR 31.205-22(a).
- Costs in connection with “planning or executing...mergers and acquisitions” are unallowable. FAR 31.205-27(a).
- DoD claimed that Raytheon included expressly unallowable salary costs associated with lobbying and corporate organization activities in the company's final indirect-cost proposals for 2007 and 2008.
- At ASBCA, Board held (1) Raytheon’s practice of recording only paid lobbying time was consistent with FAR 31.205-22, and (2) government did not show Raytheon’s organization costs were expressly unallowable under FAR 31.205-27.
- Federal Circuit held:
 - Raytheon's time-paid accounting practice necessarily charged the government for expressly unallowable costs because Raytheon employees regularly engaged in after-hours lobbying and thus the salaries paid to those employees must have included compensation for lobbying activities in violation of FAR 31.205-22; and
 - Raytheon's "bright-line" policy on organization costs was "plainly inconsistent" with FAR 31.205-27 because the portion of salaries paid for pre-planning activities is expressly unallowable because such activities are an essential part of every corporate transaction.

Polling Question

To be allowable, a cost must meet all of the following requirements EXCEPT for:

- a. Allocability
- b. Cost Accounting Standards, if applicable, and generally accepted accounting principles
- c. Reasonableness
- d. Realism
- e. The terms of the contract

Polling Question

In analyzing cost reasonableness, which consideration/factor is determinative:

- a. Generally accepted sound business practices
- b. Whether arm's-length bargaining took place
- c. The contractor's responsibilities to the Government, other customers, the business owners, employees, and the public at large
- d. The contractor's established practices
- e. None of the above. No one consideration is determinative; the analysis will depend upon a variety of considerations and circumstances.

Polling Question

Reasonableness determinations should be made based upon the circumstances existing at:

- a. The time the costs were incurred
- b. Proposal submission
- c. After the fact, when the costs are in dispute

Polling Question

If a cost is incurred specifically for a contract, that cost is said to be:

- a. Reasonable
- b. Allowable
- c. Allocable to that contract
- d. None of the above

Polling Question

Which of the following is NOT an expressly unallowable cost:

- a. Gifts and Entertainment costs
- b. Pension costs
- c. Alcohol
- d. Certain Lobbying and Political Activity costs

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