It's not intuitive. It's not black and white. It's a bit controversial, actually. But you need to know that there are different "flavors" of unallowable costs.

We've written about the situation before. Here's **a link** to a quick overview article, for those interested. Two years ago we **wrote** about some then-recent DCAA audit guidance on the topic. While we generally applauded the guidance, others were not as impressed.

In fact, we've written about expressly unallowable costs many times on this blog. Here's what you need to know:

When submitting the final indirect cost rate proposal (also known as the annual incurred cost submission), FAR 42.703-2 discusses how that proposal is to be certified. The certification is formally required by the contract clause 52.242-4 ("Certification of Final Indirect Costs"). By executing the certification, the contractor represents that all costs being claimed are allowable pursuant to the applicable cost principles, and that "This proposal does not include any costs which are expressly unallowable …"

The contract clause 52.242-3 describes what happens if a contractor includes unallowable costs in its final indirect cost rate proposal, despite its certification to the contrary. Such costs are subject to penalties. The clause prescribes—

If the Contracting Officer determines that a cost submitted by the Contractor in its proposal 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 Contractor shall be assessed a penalty equal to—

(1) The amount of the disallowed cost allocated to this contract; plus

(2) Simple interest, to be computed—

(i) On the amount the Contractor was paid (whether as a progress or billing payment) in excess of the amount to which the Contractor was entitled; and

(ii) Using the applicable rate effective for each six-month interval prescribed by the Secretary of the Treasury pursuant to Pub. L. 92-41 (85 Stat. 97).

If the Contracting Officer determines that a cost submitted by the Contractor in its proposal includes a cost previously determined to be unallowable for that Contractor, then the Contractor will be assessed a penalty in an amount equal to two times the amount of the disallowed cost allocated to this contract.

The definitions section of FAR Part 31 states—

'Expressly unallowable cost' means 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.

FAR 42.709 provides guidance to contracting officers regarding how to impose the penalties. Importantly, the FAR directs (using the imperative "shall") contracting officers to waive the penalties if –

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.

(See FAR 42.709-5 for more details. Readers wanting to dig deeper into the imposition of penalties should also look at the DCMA's Guidance to Contracting Officers for negotiating final overhead rates.)

We have written, several times, about small businesses that inadvertently claim expressly unallowable costs as allowable costs, and think the penalties should be waived. (See, for example, the stories of **Inframat** and **TAI** .) They seem surprised when the ACOs and Judges don't act as sympathetic as the contractors think they should.

Today's story is about a large business that submitted expressly unallowable costs. Today's story is about Exelis, Inc., and comes to us via the **ASBCA** . Exelis used to be part of the ITT Corporation, which used to be called ITT Industries, Inc. ITT split itself and its Defense Electronics business became Exelis. Whether you call it Exelis or ITT Defense, the company has been a large defense contractor for a long time.

Exelis established certain executive compensation plans, as many companies do. (It's an old joke that people aren't really the No.1 resource these days; the No. 1 resource is the Supplemental Executive Compensation Plan.) Some of Exelis' executive compensation plans were based (at least to some extent) on the changes in its stock price over time, relative to certain benchmarked peer companies. DCAA audited Exelis' executive compensation in 2006 and 2007, and found claimed amounts were in excess of the 31.205-6(p) ceilings in place at the time; however, no mention was made of the allowability of the plans themselves. Exelis disagreed with the DCAA audit findings, arguing that some of its executive compensation plans were excluded from calculation of executive compensation under the ceilings. That argument resulted in the ACO finding that, even if the plans should have been excluded under 31-205(p), the costs in question were expressly unallowable under 31.205-6(i), because they were determined (at least in part) based on changes to stock price.

Oops.

Long story short, Exelis and its Corporate ACO (CACO) agreed that the costs were expressly unallowable under 31.205-6(p) rather than 31.205-6(i), which was fortuitous for the government because now everything matched the DCAA audit report. Exelis paid penalties with respect to older proposals (e.g., 2004); however, by then DCAA had revised its opinion and now believed that the executive compensation was expressly unallowable under 31.205-6(i)—and Exelis disagreed with that opinion. Meanwhile, Exelis included $7,050 in claimed costs for the band at its Christmas party in its 2006 final billing rate proposal, and DCAA found that to be an expressly unallowable cost as well. Exelis did not disagree, but claimed that the cost had been inadvertently claimed through accounting error and was immaterial.

The CACO did not agree and imposed penalties. In the words of Judge Sweet (writing for the Board)—

In assessing a penalty, CACO Rivera rejected Exelis's argument that the penalties for entertainment costs should be waived under FAR 42.709-5(c) on the grounds that it had inadvertently coded the costs. CACO Rivera reasoned that Exelis did not address the requirement under FAR 42.709-5(c) that a contractor demonstrate that 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.

Exelis appealed the COFD and its appeal was denied.

The Board found that the executive compensation costs were expressly unallowable. Further, because the entertainment costs were added to the compensation costs, the total amount of expressly unallowable costs was in excess of $3 million. Thus, the only way for penalties to be waived was for Exelis to convince its CACO that it met the 42.709-5(c) requirements. However, the documents submitted to the ASBCA did not convince the Judges that Exelis deserved to have the penalties waived. Judge Sweet wrote—

… those documents do not show that, *at the time it included the entertainment costs in the 2006 indirect cost proposal* , Exelis had established policies, personnel training, and an internal control and review system that provided assurance that entertainment costs were precluded from being included in final indirect cost rate

proposals. The other documents submitted by Exelis—namely its code of corporate conduct, presentation on allowability and allocability of home office G&A expenses, and its presentation on current developments in government contracting—pre-date the 2006 indirect cost proposal. However, *those documents are general in nature*, and do not show that Exelis had established policies, personnel training, and an internal control and review system that provided assurance that entertainment costs were precluded from being included in final indirect cost rate proposals.

(Emphasis added.)

The lesson for other contractors—large and small—is clear. If you want to persuade an ACO to waive penalties associated with expressly unallowable costs that may have been inadvertently included in your proposals to establish final billing rates, you need to do several things. You must—

- Establish clear policies regarding identification and segregation of unallowable costs.

- Establish detailed procedures to assist employees in identifying unallowable costs. These procedures are not simply accounting procedures to help accounting personnel with proper account coding; they must also help other employees to properly identify unallowable costs on expense reports, check requests and other transactions.

- Train employees in the policies and procedures. Document the training. Keep a record of who has been trained and when they were trained.

- Establish strong internal control systems that provide assurance that unallowable costs are being identified and properly segregated from allowable costs.

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Establish periodic reviews—sometimes called “scrubs”—that check how well the internal control systems are working.

Seems like a lot of effort, right? Well, it *is* a lot of effort. Obviously the efforts listed above need to be proportionate to the company’s size and to the risk of inclusion of expressly unallowable costs. However, often the efforts can pay for themselves, especially when (as in the case of Exelis) there are multiple millions of dollars at stake.