Forget health care costs for a minute. Let's first lay a bit of foundation before we get into the meat of what needs to be discussed….

In Government contract cost accounting, not all costs are created equal. Beyond the distinctions between "allowable" and "unallowable" there are also "expressly unallowable" costs as well as "directly associated unallowable costs." We want to focus on the distinctions between costs that are merely unallowable and those costs that are "expressly unallowable."

When submitting the final indirect cost rate proposal (also known as the annual incurred cost submission), FAR 42.703-2 discusses that a certification must accompany the proposal. 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.

(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. Here is **a link** to get you started.)

What is meant by "expressly unallowable" has been a source of disagreement between contractors and government representatives. 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.

The foregoing definition is not particularly conducive to resolving disagreements between government and contractor. In practice, DCAA tends to assert that any unallowable cost is expressly unallowable; whereas contractors tend to believe that very few costs are expressly unallowable. Alcohol, charitable contributions, and amortization of goodwill are among the few areas of agreement. The other cost principles are fertile ground for dispute.

In June 2002, the Armed Services Board of Contract Appeals (ASBCA) discussed the concept of "expressly" unallowable costs in the appeal of General Dynamics (**ASBCA No. 49372**). Although the decision subsequently was reversed (on other grounds) on appeal, the Court's opinion stands as the most lucid discussion of the topic. The Court opined—

We do not believe the determination of 'express unallowability' can turn solely on whether the contractor made a 'good faith effort' to comply with the particular cost principle involved, although subjective good faith is important. 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. Under 10 U.S.C. § 2324(e)(1)(F), for example, the 'costs of alcoholic beverages' are unallowable and may leave little room for debate, short of a discussion of alcohol levels. On the other hand, the analysis required under 10 U.S.C. § 2324(k) is far more complicated and the answer not necessarily obvious, particularly when a settlement agreement must be consulted.
See also
10 U.S.C. § 2324(e)(1)(N), now (e)(1)(O). [Emphasis added.]

Accordingly, our position is that the “expressly unallowable” standard is a high bar and difficult for the government to impose.

The foregoing is necessary prelude for the subject of this article.

On September 24, 2010, DCMA issued **this guidance** to the DOD “Contracts Community”. The guidance was short and simple. It said—

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DCAA found that some defense contractors are inappropriately charging the Government for health benefit costs for dependents that are no longer eligible for benefits under the contractors' plans. Based on their findings, DCAA issued audit guidance on ineligible dependent health benefit costs in MRD 09-PSP-016(R). That guidance states that the costs are expressly unallowable, and therefore subject to penalties if included in a contractor's final indirect cost rate proposal.

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We have reviewed DCAA's audit guidance and agree that the costs are expressly unallowable and subject to penalties if included in a contractor's final indirect cost rate proposal.

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If the ACO determines that the costs are unallowable, the ACO shall treat the costs as expressly unallowable costs.

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As a result, we are revising the Final Overhead Instruction to ensure ACOs properly assess penalties on these costs.

We told you about DCAA's focus on "ineligible" dependent health care costs last year, in **this article** . We called the audit guidance "troubling" and made some suggestions regarding what contractors might do to prepare for DCAA's audit approach. Subsequently, we've learned more about this topic (mostly from contractors who have been audited) and we think it's a tempest in a teapot. Quite simply, the amount of costs at issue just isn't that big.

But we think the government is going to have trouble meeting the standard established by the ASBCA regarding the test for "expressly unallowable" costs—particularly with respect to the "grace periods" offered to employees who need to report changes in the eligibility of dependents.

That said, we're also concerned by DCMA's guidance, which continues a troubling trend of reducing the discretion of Contracting Officers in favor of centralized direction. The current DCMA guidance (link above) requires that an Administrative Contracting Officer (ACO) must generate "an affirmative statement that the ACO agreed or disagreed with each finding and recommendation made by DCAA or DCMA specialists … and whether or not the assessment of any penalties and interest is appropriate." We have difficulty seeing why the ACO needs to follow that direction, when there is no discretion to disagree.