It's relatively basic stuff that every government contractor should know. You have to identify and then segregate "unallowable" costs from your proposals, billings, and other things (like claimed indirect cost rates). It's right there in FAR 31.201-6 ("Accounting for Unallowable Costs"). Every contractor selling non-commercial items has to comply. It's basic government compliance—like blocking or tackling in (American) football.

Determining exactly which costs are "unallowable" is a lot trickier. You need to thoroughly review FAR Part 31, paying special attention to the list of selected costs at 31.205. You need to know a few court cases and, perhaps, read a few books on the topic. It's tricky because it requires an application of judgment.

And, if you want to get into even harder stuff, you also need to identify and segregate "directly associated" unallowable costs. Further, as we've **explained** before, there's a difference between garden-variety unallowable costs and "expressly" unallowable costs, in terms of penalties for failing to properly exclude those costs from your rate calculations, proposals, and/or billings.

So yes, the topic of "unallowable" costs is both broad and deep, but government contractors still need to know about it, and comply with the requirements. In order to comply, some small contractors hire consultants to review their books and to find the unallowable costs—which is not a bad plan because those consultants have the expertise to support their judgments. Other small contractors have outside bookkeepers who are also supposed to identify unallowable costs—which is a risky approach unless you are sure those bookkeepers (or CPAs) have the right expertise. (We don't believe that knowledge of FAR Part 31 is tested on the CPA exam.)

As contractors grow and can afford additional staff, they hire accountants or billing specialists or Controllers or compliance folks who review accounting transactions for allowability in a more timely manner. Those professionals are hired for their expertise, and it's usually a good investment—because it's cheaper to pay (allowable) salaries and benefits than it is to pay unallowable penalties and interest (or lawyers' fees, in extreme cases).

But here's the thing: No matter what compliance approach you choose as a contractor, *you cannot possibly afford to pay for every single transaction to be reviewed by somebody with the requisite expertise*

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You cannot afford to pay for every expense report to be reviewed (along with all the receipts) in order to check if somewhere, sometime, somebody got reimbursed for a beer at dinner—and then to see if the cost of that beer was identified and properly recorded as an unallowable cost. You can't afford to pay for somebody to review every single check request, or vendor invoice, or accounts payable transaction. You simply can't.

Instead, what you do is have robust policies and procedures and guidance. You have training for employees and supply chain managers and buyers and expense report processors and accounts payable staff, and you have additional training for supervision and management who review and approve transactions. You have special focused training for program managers and for business development folks. You very clearly tell your people what costs are reimbursable, and then which of those costs are going to be allowable and which are going to be unallowable.

You have to do all that because, no matter how hard you try, if you rely on "SMEs" to identify your unallowable costs, something is going to slip through. Anybody you hire from the outside is going to rely on some kind of transaction sample in order to calculate a percentage of unallowable costs (which they are permitted to do). Your employees are going to be looking at a bigger sample of transactions—and you may think it's 100 percent—but something is going to slip through. That's just human nature. We're all fallible and that's the way it is.

Finally, your own employees may point out to management that an error has been made somewhere in the many upon many accounting transactions that make up a year's general ledger. The employees may report their concerns and it would behoove you to listen to those concerns, and to make corrections to any cost that was misclassified as an allowable cost when it should have been an unallowable cost.

With all that as background, let's look at this Department of Justice **press release** .

The press release announced that Integral Consulting Services, Inc. (Integral or ICS), a "self certified small disadvantaged business" and a "economically disadvantaged women owned small business" (according to **this webpage**), had settled a False Claims Act lawsuit filed by a former employee for "over a half-million dollars" (actually $505,838). That's a relatively trivial amount, as such things go. But remember that Integral is a small business, reportedly with only 80+ employees and just over $6 million in annual revenues (as per the previously linked webpage). So $500K is a pretty huge hit to the company's bottom-line—and that doesn't take into account the attorney's fees paid to negotiate the legal settlement with DoJ.

What did the company do wrong? According to the press release—

The civil settlement agreement resolves allegations that from on or about May 1, 2012 through June 27, 2014, ICS took costs and expenses it and its employees incurred in connection with litigation arising out of a teaming agreement with another contracting company and included the costs and expenses in the General and Administration ('G&A') indirect cost pool that was spread amongst ICS's various government contracts … and submitted to the United States government. The inclusion of such costs had the effect of inflating the claims paid by the Army to ICS.

As best we understand the situation from the above brief description, Integral claimed certain legal costs made unallowable by 31.205-47 as allowable costs. (See FAR 31.205-47(f)(5).) That cost principle states—

Costs of legal, accounting, and consultant services and directly associated costs incurred in connection with the defense or prosecution of lawsuits or appeals between contractors arising from either—

(i) An agreement or contract concerning a teaming arrangement, a joint venture, or similar arrangement of shared interest; or

(ii) Dual sourcing, coproduction, or similar programs, are unallowable, except when—

(A) Incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer, or

(B) When agreed to in writing by the contracting officer.

Thus, legal costs incurred in connection with litigation arising out of a teaming agreement were not allowable. They may well have been expressly unallowable. Somebody at Integral didn't review an invoice from outside counsel, and thus didn't properly classify the cost as unallowable.

What's interesting about this situation is that, normally, this is handled via an administrative remedy and not by a lawsuit. DCAA finds the cost and tells the ACO, and the ACO tells the contractor to pay the appropriate penalty and interest. It's not particularly fun, but it's not a big deal, either. What makes Integral's situation different is that an employee noticed the misclassification of the cost, and filed a *qui tam* suit on behalf of the government—and then got a bounty of more than $90,000 for doing so.

We don't know why the employee felt the need to file a suit. Did they try to report it and get rebuffed by company management? It's certainly possible. Looking at Glassdoor, the company has decidedly mixed reviews. Many people love it but many people also had negative comments about management style and a perceived lack of integrity. It's possible that somebody tried to report the misclassification and was rebuffed—just as it's possible that the transaction was simply missed by those charged with the responsibility of making sure only allowable costs were claimed in proposals, rate calculations, and billings.

One more thing: missed unallowable costs in G&A expense pools can be bad things, because G&A is allocated to all active cost objectives. Under the False Claims Act, each invoice submitted under each contract becomes a separate claim. Thus, if the G&A rate is "inflated" through inclusion of unallowable costs, then every invoice submitted under each contract was also inflated. The current FCA states each false claim may create a liability ranging from $5,500 to $11,000. *That's per claim*. And that's regardless of the dollar value of the "inflation" as allocated to each claim. Readers need to carefully think about that, before they do a superficial sample of G&A expense pool transactions as part of identification and segregation of unallowable costs.