



**DEFENSE CONTRACT AUDIT AGENCY  
DEPARTMENT OF DEFENSE  
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IN REPLY REFER TO

PAC 730.3.B.01/2014-05

January 7, 2015  
14-PAC-022(R)

**MEMORANDUM FOR REGIONAL DIRECTORS, DCAA  
HEADS OF PRINCIPAL STAFF ELEMENTS, HQ, DCAA**

**SUBJECT: Audit Alert on Identifying Expressly Unallowable Costs**

This audit alert enhances the guidance regarding identifying expressly unallowable costs. We are providing it to assist audit teams with making determinations whether specific cost principles identify expressly unallowable costs. Audit teams also should refer to MRD 14-PAC-021(R), Audit Alert Distributing a Listing of Cost Principles that Identify Expressly Unallowable Costs, and the listing provided as an enclosure to that MRD when making those determinations.

**Determining Whether a Cost Principle Identifies Expressly Unallowable Costs**

In order for a cost to be expressly unallowable, 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. Thus, a cost principle makes costs expressly unallowable if:

1. It states in direct terms that the costs are unallowable, or leaves little room for differences of opinion as to whether the particular cost meets the allowability criteria; and
2. It identifies the specific cost or type of costs in a way that leaves little room for interpretation.

**Language of the Cost Principle Concerning Allowability**

**Stated in Direct Terms**

In situations where the cost principle states in direct terms that the cost is unallowable or not allowable, it is easy to determine whether the cost is expressly unallowable. In those situations, there is no doubt that the costs questioned based on the cost principle are expressly unallowable.

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### Not Stated in Direct Terms

In many situations, we question costs based on cost principles that do not state in direct terms that the cost is unallowable. In those situations, determining whether the cost is expressly unallowable becomes more of a challenge.

The mere fact that the cost principle does not include the word unallowable or phrase not allowable does not mean that costs questioned based on that cost principle are not expressly unallowable. This was clearly established, in *Emerson Electric Co.*, ASBCA No. 30090, 87-1 BCA ¶19,478 (Nov. 19, 1986). In that case, the Board stated, “With regard to CAS 405, the CAS Board clearly intended the word ‘expressly’ in the phrase ‘expressly unallowable cost’ to be understood in the ‘broad dictionary sense,’ rather than as a term of art having some special, subtle meaning. According to the CAS Board, the unallowability of a cost item must be expressed in either ‘direct or unmistakable terms’.” The Board ruled that although the regulation did not state that foreign selling costs were unallowable, the only logical interpretation of the language was that they were expressly unallowable.

In *General Dynamics Corp.*, ASBCA No. 49732, 02-2 BCA ¶ 31,888, *reversed on other grounds*, *Rumsfeld v. General Dynamics Corp.*, 365 F.3d 1380 (Fed. Cir. 2004), the Board stated that the standard for whether a cost is expressly unallowable is objective and the Government bears the burden of proof in assessing a penalty. The Board ruled that the Government should not assess a penalty where there are reasonable differences of opinion about the allowability of costs and that 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.” In situations where it is not directly stated in a cost principle, in order for a cost or type of cost to be expressly unallowable, the cost principle must identify it clearly enough that there is little room for difference of opinion as to whether a particular cost meets the criteria.

In summary, a cost can be expressly unallowable even though the cost principle does not explicitly state that the cost is unallowable or not allowable. However, in those situations, the audit team will have to make a determination regarding whether the cost principle, used as the basis for questioning the costs, identifies expressly unallowable costs. In order for the cost to be expressly unallowable, it is not enough that our logical interpretation of the language is that the questioned costs are expressly unallowable. The Government must establish that it was “unreasonable under all the circumstances for a person in the contractor’s position to conclude that the costs were allowable.” Therefore, in situations where a cost principle does not specifically state that the applicable cost is unallowable or not allowable, the audit team will have to employ critical thinking when determining whether the cost principle identifies expressly unallowable costs. The audit team will need to analyze whether the cost principle identifies a cost or type of cost clearly enough that there cannot be a reasonable difference of opinion as to whether a questioned cost meets the criteria specified.

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**Assistance with Determinations:**

In order to assist audit teams with determining whether cost principles identify expressly unallowable costs, we provided a listing of cost principles in FAR Part 31 or DFARS Part 231 that identify expressly unallowable costs. The list was distributed as an enclosure to MRD 14-PAC-021(R), dated December 18, 2014, titled, Audit Alert Distributing a Listing of Cost Principles that Identify Expressly Unallowable Costs. To assist audit teams further with making these determinations, we also are providing in an enclosure to this memorandum, examples of cost principles that, in our opinion, identify expressly unallowable costs and examples of cost principles that in our opinion do not. The examples include cost principles that state in direct terms in the plain language of the cost principle that the cost is unallowable or not allowable. The examples also include samples of cost principles that do not directly state the cost is unallowable; however, in our opinion, the cost principles still identify expressly unallowable costs. For those cost principles, we have provided an interpretation that explains the basis for our conclusions. There also are examples of cost principles that, in our opinion, do not identify expressly unallowable costs. For those cost principles, we also have included interpretations that explain the basis for our conclusions.

**Questions and Further Information**

FAO personnel should direct questions regarding this memorandum to their regional offices, and regional personnel should direct any questions to Accounting and Cost Principles Division at (703) 767-3250 or by e-mail at DCAA-PAC@dcaa.mil.

/Signed/  
Donald J. McKenzie  
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Enclosure:

Examples of Cost Principles that Identify or  
Do Not Identify Expressly Unallowable Costs

DISTRIBUTION: E

## **Examples of Cost Principles that Identify or Do Not Identify Expressly Unallowable Costs**

### **Expressly Unallowable**

#### Stated in Direct Terms

- **FAR 31.205-8 -- Contributions or Donations.**  
Contributions or donations, including cash, property and services, regardless of recipient, are unallowable, except as provided in 31.205-1(e)(3).
- **FAR 31.205-51 -- Costs of Alcoholic Beverages.**  
Costs of alcoholic beverages are unallowable.

#### Not Stated in Direct Terms

- **FAR 31.205-13(d)(1)**

#### Cost Principle:

The allowability of food and dormitory losses are determined by the following factors:

- (i) Losses from operating food and dormitory services are allowable only if the contractor's objective is to operate such services on a break-even basis.
- (ii) Losses sustained because food services or lodging accommodations are furnished without charge or at prices or rates which obviously would not be conducive to the accomplishment of the above objective in paragraph (d)(1)(i) of this subsection are not allowable, except as described in paragraph (d)(1)(iii) of this subsection.
- (iii) A loss may be allowed to the extent that the contractor can demonstrate that unusual circumstances exist such that even with efficient management, operating the services on a break-even basis would require charging inordinately high prices, or prices or rates higher than those charged by commercial establishments offering the same services in the same geographical areas.

#### Interpretation:

The cost principle indicates that the cost is allowable if it meets certain criteria. It does not use the term unallowable or not allowable. However, the only logical interpretation of the language is that if the criteria, "the contractor's objective is to operate such services on a break-even basis" is not met, the cost is unallowable and, therefore, costs questioned, using this cost principle as a basis, are expressly unallowable.

## Determined in a Court Case

### ➤ **31.205-19(e)(2)(v)**

#### Cost Principle:

Costs of insurance on the lives of officers, partners, proprietors, or employees are allowable only to the extent that the insurance represents additional compensation (see 31.205-6).

#### Interpretation:

The cost principle indicates that the cost is allowable if it meets certain criteria. It does not use the term unallowable or not allowable. However, the only logical interpretation of the language is that if the criteria, the costs of insurance on the lives of officers, partners, proprietors, or employees represents additional compensation, is not met, the cost is unallowable. Therefore, costs questioned, using this cost principle as a basis, are expressly unallowable. Additionally, in *Thomas Assoc., Inc.*, ASBCA No. 57126, 11-1 BCA ¶ 34,764, the Board considered the cost of insurance premiums that the contractor had not treated as compensation expressly unallowable costs.

## Not Expressly Unallowable

### Reasonableness Criteria

### ➤ **FAR 31.201-2(a)(1)**

#### Cost Principle:

(a) A cost is allowable only when the cost complies with all of the following requirements:

- (1) Reasonableness.

#### Interpretation:

There is an overarching allowability statement within FAR 31.201-2(a) that, “A cost is allowable only when the cost complies with all of the following requirements,” one of which is reasonableness. This statement does not clearly identify a particular cost or type of costs and there could easily be rational differences of opinion as to whether a particular cost is reasonable. Thus, while costs that are not reasonable are unallowable, they are not expressly unallowable.

➤ **FAR 31.205-6(a)(2)**

Cost Principle:

- (a) General. Compensation for personal services is allowable subject to the following general criteria and additional requirements contained in other parts of this cost principle:
- (2) The total compensation for individual employees or job classes of employees must be reasonable for the work performed; however, specific restrictions on individual compensation elements apply when prescribed.

Interpretation:

This cost principle requires that costs be **reasonable for the work performed** in order to be allowable. However, there is room for differences of opinion as to what level of compensation is reasonable for work performed. Thus, while costs that are not reasonable for the work performed are unallowable, they are not expressly unallowable.

Allocability Criteria

➤ **FAR 31.201-2(a)(2)**

Cost Principle:

- (a) A cost is allowable only when the cost complies with all of the following requirements:
- (2) Allocability.

Interpretation:

There is an overarching allowability statement within FAR 31.201-2(a) that, “A cost is allowable only when the cost complies with all of the following requirements,” one of which is allocability. This statement does not identify a particular cost or type of costs and there could easily be rational differences of opinion as to whether a particular cost is allocable. Thus, while costs that are not allocable are unallowable, they are not expressly unallowable.

➤ **FAR 31.205-18(c)**

Cost Principle:

Allowability. Except as provided in paragraphs (d) and (e) of this subsection, or as provided in agency regulations, costs for IR&D and B&P are allowable as indirect expenses on contracts to the extent that those costs are allocable and reasonable.

Interpretation:

Determining whether a particular cost is allocable and reasonable is a matter in which there is room for reasonable differences of opinion. Thus, this cost principle does not identify expressly unallowable costs.

#### Terms of the Contract

➤ **FAR 31.201-2(a)(4)**

Cost Principle:

(a) A cost is allowable only when the cost complies with all of the following requirements:

(4) Terms of the contract.

Interpretation:

There is an overarching allowability statement within FAR 31.201-2(a) that, “A cost is allowable only when the cost complies with all of the following requirements,” one of which is the terms of the contract. This statement does not identify a particular cost or type of costs and there could easily be reasonable differences of opinion as to whether a particular cost does not comply with certain contract terms. Thus, while costs that do not comply with contract terms are unallowable, they are not expressly unallowable. In addition, FAR 42.709-1(a)(1) provides for penalties, “If the indirect cost 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.” Accordingly, penalties only apply related to unallowable indirect costs. Thus, while direct costs that we question because they do not comply with the contract terms are unallowable, they are not expressly unallowable and would not be subject to penalty.

#### Subjective Criteria

➤ **FAR 31.205-6(a)(3)**

Cost Principle:

(a) General. Compensation for personal services is allowable subject to the following general criteria and additional requirements contained in other parts of this cost principle:

(3) The compensation must be based upon and conform to the terms and conditions of the contractor’s established compensation plan or practice followed so consistently as to imply, in effect, an agreement to make the payment.

Interpretation:

This provision states, “The compensation must be based upon ... the contractor’s ... practice followed so consistently as to imply, in effect, an agreement to make the payment.” This does not provide a clear and objective standard by which to determine whether or not a cost is allowable. There could easily be reasonable differences of opinion as to whether the compensation is based upon the contractor’s practice followed **so consistently as to imply**, in effect, an agreement to make the payment. Thus, while costs that do not meet this criteria would be unallowable, they are not expressly unallowable.

➤ **FAR 31.205-43(c)**

Cost Principle:

The following types of costs are allowable:

(c) When the principal purpose of a meeting, convention, conference, symposium, or seminar is the dissemination of trade, business, technical or professional information or the stimulation of production or improved productivity --

(3) Costs of attendance by individuals who are not employees of the contractor, provided --

(i) Such costs are not also reimbursed to the individual by the employing company or organization, and

(ii) The individuals attendance is essential to achieve the purpose of the conference, meeting, convention, symposium, etc.

Interpretation:

There is an overarching allowability statement within FAR 31.205-43(c), “The following types of costs are allowable,” which includes the costs of attendance by individuals who are not employees of the contractor, if certain conditions are met. One of the conditions is that, “The individuals attendance is essential to achieve the purpose of the conference, meeting, convention, symposium, etc.” This is not a clear and objective standard by which to determine whether a cost is allowable. There could easily be reasonable differences of opinion as to whether the “The individuals attendance is **essential** [emphasis added] to achieve the purpose of the conference, meeting, convention, symposium, etc.” Therefore, while costs that do not meet the criteria may be unallowable, they are not expressly unallowable.

Requires Application of Criteria Beyond the Cost Principle

➤ **FAR 31.205-6(a)(1)**

Cost Principle:

(a) General. Compensation for personal services is allowable subject to the following general criteria and additional requirements contained in other parts of this cost principle:



(1) Compensation for personal services must be for work performed by the employee in the current year and must not represent a retroactive adjustment of prior years' salaries or wages (but see paragraphs (g), (h), (j), (k), (m), and (o) of this subsection).

Interpretation:

This provision describes criteria for allowability but does not state in direct terms that the cost is unallowable if it does not meet the criteria. Additionally, the allowability criteria refers to general criteria and additional requirements contained in other parts of the cost principle and to possible exceptions in paragraphs (g), (h), (j), (k), (m), and (o). The general criteria, additional requirements, and exceptions are so broad that the cost principle does not contain a clear and objective standard by which to determine whether a cost is unallowable. Therefore, it is unlikely we would question costs based on this cost principle and, if we did, they would not be expressly unallowable.

➤ **FAR 31.205-52(a)**

Cost Principle:

For tangible capital assets, when the purchase method of accounting for a business combination is used, whether or not the contract or subcontract is subject to CAS, the allowable depreciation and cost of money shall be based on the capitalized asset values measured and assigned in accordance with 48 CFR 9904.404-50(d), if allocable, reasonable, and not otherwise unallowable.

Interpretation:

This provision describes criteria for allowability but does not state in direct terms that the cost is unallowable if it does not meet the criteria. Additionally, the allowability criteria requires us to apply a standard outside of the cost principle, 48 CFR 9904.404-50(d), to determine allowability. That standard has additional criteria and requirements that can result in issues themselves. Therefore, there is no clear and objective standard in the cost principle by which to determine whether a cost is unallowable. Accordingly, although costs may be unallowable based on this cost principle, they would not be expressly unallowable.

No Direct Statement Regarding Allowability and Does Not Provide Allowability Criteria

➤ **FAR 31.205-6(o)(2)(ii)(B)**

Cost Principle:

(o) Postretirement benefits other than pensions (PRB).

(2) To be allowable, PRB costs shall be incurred pursuant to law, employer-employee agreement, or an established policy of the contractor, and shall comply with paragraphs (o)(2)(i), (ii), or (iii) of this subsection.

(ii) Terminal funding. PRB costs are not accrued during the working lives of the employees.

(B) Terminal funded costs shall be amortized over a period of 15 years.

Interpretation:

This provision requires contractors to amortize terminal funded costs over 15 years. However, it does not state in direct terms that if the contractor does not comply with this requirement that the cost is unallowable. Additionally, although there is an overarching criteria for allowability within FAR 31.205-6(o)(2), "To be allowable, PRB costs **shall** [emphasis added]...", it is not in this specific statement. Therefore, although costs may be unallowable based on this cost principle, they would not be expressly unallowable.

➤ **DFARS 231.205-19(e)**

Cost Principle:

In addition to the cost limitations in FAR 31.205-19(e), self-insurance and purchased insurance costs are subject to the requirements of the clauses at 252.217-7012, Liability and Insurance...

DFARS 252.217-7012(b)(6) states, "Notwithstanding the foregoing, the Contractor shall bear the first \$50,000 of loss or damage from each occurrence or incident, the risk of which the Government would have assumed under the provisions of this paragraph (b)."

Interpretation:

This provision provides that in addition to the cost limitations in FAR 31.205-19(e), insurance costs also are subject to the requirements of the clauses at DFARS 252.217-7012, Liability and Insurance. However, it does not state in direct terms that if a cost does not comply with those requirements that it is unallowable. Additionally, neither it, nor the additional requirements, contains a description of criteria for allowability. Therefore, although costs may be unallowable based on this cost principle, they would not be expressly unallowable.