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NEWSLETTER

DCAA Offers Some Relief from Recent "Expressly Unallowable" Cost Decisions, But Risks Remain

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The Defense Contract Audit Agency (DCAA) updated its "expressly unallowable costs" guidance for the first time since 2015, following decisions by the Armed Services Board of Contract Appeals (ASBCA) on "expressly unallowable costs," including disputes over costs associated with lobbying and political activities. *See* DCAA MRD 19-PAC-002(R) (May 14, 2019). This updated guidance attempts to reconcile an apparent divergence between the ASBCA caselaw and prior DCAA guidance. While the updated guidance may lead to greater predictability in how DCAA will approach the issue of whether costs not identified in the FAR or DFARS as "expressly unallowable" should, in fact, be deemed "expressly unallowable," it may also increase the risk that contractors could be subject to penalties for incorrectly seeking reimbursement of a broader array of unallowable costs where there are "unique facts and circumstances." The updated guidance also adopts a seeming arbitrary line drawn by the ASBCA (and recently upheld by the United States Court of Appeals for the Federal Circuit) in its treatment of salary and bonus compensation for employees engaged in lobbying and political activity.

FAR Cost Principles

The cost principles outlined in FAR Part 31 describe the types of costs that are "expressly unallowable" as charges to the Government under cost-type contracts. FAR 31.206, Accounting for Unallowable Costs, prescribes the appropriate treatment of these costs. Contractors must identify and exclude unallowable costs from all

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invoices, bills, or proposals submitted under a U.S. Government contract (such as annual incurred cost submissions under FAR 52.242-3). FAR 31.206(a) further provides that "[a] directly associated cost is any cost that is generated solely as a result of incurring another cost, and that would not have been incurred had the other cost not been incurred. When an unallowable cost is incurred, its directly associated costs are also unallowable." The Government bears the burden of proving that a submitted cost is unallowable, and the ASBCA requires the Government to "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 FAR, as well as the Cost Accounting Standard 405, define an "expressly unallowable cost" as "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 inclusion of expressly unallowable costs in submissions to the Government can result in penalties up to two times the amount of a disallowed cost, and therefore contractors and the Government often dispute whether submitted costs later found to be unallowable are "expressly unallowable" and therefore subject to the penalty provisions.

ASBCA Expressly Unallowable Lobbying Cost Decisions

One FAR cost principle, FAR 31.205-22, Lobbying and Political Activity Costs, was at issue in recent ASBCA cases on expressly unallowable costs, which helped precipitate DCAA's updated guidance. The prohibition includes six enumerated types of costs that are expressly unallowable. With a handful of exceptions, generally a contractor must exclude costs for attempts to influence elections, legislation, or referendums; legislative liaison activities supporting efforts to engage in unallowable activities; attempts to improperly influence congressional or federal employees to give consideration to or act regarding a regulatory or contract matter; and contributions to political parties, political action committees (PAC) or similar organizations.

In *Raytheon Co.*, ASBCA No. 57743, 17-1 B.C.A. ¶ 36,724 (Apr. 17, 2017), the contractor disputed several cost issues that arose from its annual incurred cost submissions, and ultimately prevailed on many of those issues during negotiations and in the appeal. For example, the ASBCA sided with the contractor in finding that FAR 31.205-46(c), Travel Costs, does not specifically name "aircraft fractional lease costs" as unallowable, so the "expressly unallowable" penalty did not apply. But the ASBCA ruled against Raytheon on a remaining dispute over whether employee salaries related to unallowable political activity costs were "expressly unallowable" and thus subject to penalties. Among the costs at issue on appeal were salaries and other employment expenses for employees who at times engaged in lobbying activity. The ASBCA upheld DCAA's determination that these were "expressly unallowable costs."

The lobbying cost principle, FAR 31.205-22, does not specifically mention salaries or compensation. The contractor argued that even if its compensation costs were unallowable, FAR 31.201-6(e)(2)—which states that salary expenses for "employees who participate in activities that generate unallowable costs shall be treated as directly associated costs to the extent of the time spent on the proscribed activity"—dictates that the unallowable salary costs be treated as "directly associated costs," not "expressly unallowable costs" subject

to penalty. Previously, the ASBCA held that bonus and incentive compensation (BAIC) for employees who were engaged in lobbying activities were not "expressly unallowable," even if they were unallowable as directly associated costs. *Raytheon Co.*, ASBCA No. 57576, 15-1 BCA ¶ 36,043 (June 26, 2015). In that decision, the ASBCA stated that
"[n]either 'BAIC' cost nor 'compensation' cost are specifically named and stated as unallowable under [FAR 31.205-22], nor are such costs identified as unallowable in any direct or unmistakable terms." Despite this earlier ruling that Raytheon's BAIC costs were not expressly unallowable, the ASBCA pivoted and held that Raytheon's salary costs were expressly unallowable, holding that "material salary expenses of employees who engage in activities that generate unallowable lobbying costs are named and stated to be unallowable under the combination of FAR 31.201-6(a) and FAR 31.201-6(e)(2)." Recently, the Federal Circuit affirmed the ASCBA's decision in *Raytheon Co. v. Secretary of Defense*, No. 18-2371 (Oct. 18, 2019) holding that despite the language of the cost principle, the intention was to include salaries under "costs associated with" lobbying.

In so holding, the ASBCA appeared to expand the range of costs that could be subject to penalties for inclusion in the submission, even while taking a more textual view of other FAR cost principles. Its interpretation of the FAR cost principles appeared to go beyond the plain language of the lobbying cost principle in FAR 31.205-22, and relied on other sections of FAR Part 31 and the ASBCA's innate "common sense" that salaries were obviously an "express" part of unallowable lobbying costs.

DCAA Guidance

DCAA has provided guidance to its auditors for determining whether FAR and DFARS cost principles amount to "expressly unallowable costs" through Memorandums for Regional Directors (MRD). Contractors use these MRDs to anticipate how auditors will treat various costs, and to structure their accounting practices accordingly. The MRDs specifically provide lists of FAR and DFARS cost principles that DCAA presumes to be "expressly unallowable," with a caveat that the list is not "comprehensive." DCAA has sought before to expand the scope of what costs are "expressly unallowable," even where the cost principles are not so explicit.

For example, DCAA's 2014 MRD included multiple FAR and DFARS cost principles that did not include costs "specifically named or stated to be unallowable," but which DCAA would treat as expressly unallowable—such as certain lease costs under FAR 32.201-11(h)(1), which identifies limits on an "allowable" cost but does not separately identify any specifically "unallowable" cost. In 2015, DCAA issued another MRD that it claimed "enhanced" the 2014 MRD, and which further emphasized that "[t]he 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." Contrary to the FAR definition of "expressly unallowable costs," but consistent with the ASBCA's decisions expanding the scope of the term beyond a plain reading of the cost principles, contractors lacked clear guidance.

Enter DCAA's May 2019 MRD, which "supersedes" prior guidance and addresses some of the gaps between

DCAA's guidance and the ASBCA's case law, on one hand, and the plain language of the FAR on the other. The 2019 MRD, however, does not fully close the gap between the ASBCA's broader approach to determining whether costs are expressly unallowable based on common sense and whether the relevant FAR/DFARS cost principle specifically identifies the cost as "expressly unallowable." Notably, the 2019 MRD deleted prior references to *Emerson Electric Co.*, ASBCA No. 30090, 87-1 BCA ¶19,478 (Nov. 19, 1986), which DCAA had cited as a basis for identifying such "expressly unallowable costs." In *Emerson*, the ASBCA held that "expressly" should be defined "in the 'broad dictionary sense,'" meaning that where the "only logical interpretation" is that costs are unallowable, they are expressly unallowable. In jettisoning references to Emerson and the decision's interpretation that costs would be deemed expressly unallowable where that is the "only logical interpretation" of the cost principle, DCAA takes a step forward to conform its guidance to the FAR and CAS definition of "expressly unallowable." But DCAA takes a step backward by also allowing for a finding of expressly unallowable costs under "unique facts and circumstances," and continuing to include several cost principles on its "expressly unallowable" list in the MRD, despite the absence of language in the FAR that these costs are "specifically named and stated to be unallowable." Whether DCAA's actual practice will narrow, or if it will continue expanding its discretion to deeming a cost expressly unallowable under the ASBCA's "common sense" approach, is yet to be revealed.

As for DCAA's treatment of lobbying and political activity costs, the 2019 MRD leaves FAR 31.205-22 in its entirety on the list of presumptively expressly unallowable cost principles, despite culling the list from 110 to 91 principles. The MRD, however, revised the "notes" regarding FAR 31.205-22 to incorporate the two *Raytheon* lobbying cost decisions discussed above. The notes attempt to reconcile the ASBCA's divergent approaches embracing the distinction the ASBCA adopted between BAIC and salary costs.

Conclusion

Wiley Rein has extensive experience assisting government contractors throughout the entire contracting and compliance life cycle, including DCAA audits and cost accounting litigation at the Boards of Contract Appeals. The updated MRD will hopefully be a welcome relief to contractors which should have more certainty on how DCAA intends to treat "expressly unallowable costs," particularly for cost principles that have been removed from the MRD list. Yet questions remain on how the new guidance will be implemented in practice by DCAA auditors on the ground, and whether any further updates will be made to address the inconsistencies that remain between the guidance and the FAR language. The fact that DCAA issued this new MRD on "expressly unallowable costs" may also signal that the agency intends to focus on its updated list of expressly unallowable cost principles to more vigorously pursue penalties against contractors that submit such costs to the Government.