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NEWSLETTER

For Federal Contractors with Lobbying and Political Costs, DCAA Offers Some Relief from Recent 'Expressly Unallowable' Cost Decisions, But Risks Remain

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Following several decisions from the Armed Services Board of Contract Appeals (ASBCA) on "expressly unallowable costs" from recent years – including disputes over some costs associated with lobbying and political activities – the Defense Contract Audit Agency (DCAA) has updated its "expressly unallowable costs" guidance. *See* DCAA MRD 19-PAC-002(R) (May 14, 2019). The guidance was last updated in 2015. The inclusion of expressly unallowable costs in submissions to the government can result in penalties up to two times the amount of the disallowed cost. Given the Board's decisions, and DCAA's role in reviewing contractor cost submissions generally in the first instance, this updated guidance should provide increased predictability for U.S. federal contractors when identifying allowable and unallowable costs before submission to the government for reimbursement. But questions still remain, particularly for arbitrary lines between certain types of compensation for lobbying and political activity costs.

FAR Cost Principles and Lobbying and Political Activities

U.S. federal government contractors must adhere to many regulations, starting with the Federal Acquisition Regulation (FAR) that include cost principles in FAR Part 31. These cost principles, among other things, describe the types of costs that are "expressly unallowable" as charges to the government under cost-type contracts. The FAR, as well as the Cost Accounting Principle 405, define an "expressly unallowable cost" as "a particular item or type of cost which, under

Authors

George E. Petel
Partner
202.719.3759
gpetel@wiley.law

Practice Areas

Election Law & Government Ethics
Government Contracts

the express provisions of an applicable law, regulation, or contract, is specifically named and stated to be unallowable."

FAR 31.206, Accounting for Unallowable Costs, prescribes the appropriate treatment of these costs. Contractors must identify and exclude unallowable costs from all invoices, bills, or proposals submitted under a U.S. government contact, such as in 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." Contractors and the government often dispute whether submitted costs later found to be unallowable are "expressly unallowable," because only "expressly unallowable" costs are subject to significant monetary penalties and not merely exclusion from payment.

One of the FAR cost principles, FAR 31.205-22, Lobbying and Political Activity Costs, was at issue in recent expressly unallowable cost cases that likely precipitated DCAA's updated guidance. FAR 31.205-22(a) prohibits contractors from charging the U.S. government for these activities:

- Attempts to influence the outcomes of any federal, state, or local election, referendum, initiative, or similar procedure, through in-kind or cash contributions, endorsements, publicity, or similar activities;
- Establishing, administering, contributing to, or paying the expenses of a political party, campaign, political action committee, or other organization established for the purpose of influencing the outcomes of elections;
- Any attempt to influence (i) the introduction of federal, state, or local legislation, or (ii) the enactment or modification of any pending federal, state, or local legislation through communication with any member or employee of the Congress or state legislature (including efforts to influence state or local officials to engage in similar lobbying activity), or with any government official or employee in connection with a decision to sign or veto enrolled legislation;
- Any attempt to influence (i) the introduction of federal, state, or local legislation, or (ii) the enactment or modification of any pending federal, state, or local legislation by preparing, distributing or using publicity or propaganda, or by urging members of the general public or any segment thereof to contribute to or participate in any mass demonstration, march, rally, fundraising drive, lobbying campaign, or letter writing or telephone campaign;
- Legislative liaison activities, including attendance at legislative sessions or committee hearings, gathering information regarding legislation, and analyzing the effect of legislation, when such activities are carried on in support of or in knowing preparation for an effort to engage in unallowable activities; or
- Costs incurred in attempting to improperly influence (see 3.401), either directly or indirectly, an employee or officer of the Executive branch of the federal government to give consideration to or act regarding a regulatory or contract matter.

There are exceptions further explained in the FAR, but generally a contractor must exclude costs for attempts to influence elections, legislation, or referendums; legislative liaison activities when in support of an effort 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 (PACs), or similar organizations.

ASBCA Expressly Unallowable Lobbying Cost Decisions

The government bears the burden of proving that a 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." 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. But the Board found against Raytheon on a remaining dispute of whether salaries related to unallowable political activity costs were "expressly unallowable" and thus subject to penalties.

After a DCAA audit and subsequent negotiations with its Administrative Contracting Officer (ACO), the contractor filed an appeal at the Board on the remaining disputes. Among the costs remaining at issue for appeal were salaries and other employment expenses for employees who at times engaged in lobbying activity. The Board upheld DCAA's determination that such costs were "expressly unallowable costs" and thus subject to penalties.

The lobbying cost principle, FAR 31.205-22, does not specifically mention salaries or compensation. The contractor had thus argued that even if the costs were unallowable, FAR 31.201-6(e)(2)[1] provides that the salaries for staff participating in unallowable costs – such as lobbying – are "directly associated costs," which are separately defined in the FAR from "expressly unallowable costs." Indeed, previously, the Board had held that bonus and incentive compensation (BAIC) for employees of the same contractor 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). The Board had 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." Yet the Board in the later case held that the salary costs were expressly unallowable, stating that "[M]aterial 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)."

By going beyond the plain language of the lobbying cost principle and relying on these other sections of FAR Part 31, as well as its "common sense" that salaries were obviously an "express" part of unallowable lobbying costs, the Board appeared to expand the range of costs that could be subject to penalties for inclusion in the submission.

DCAA Guidance

DCAA has provided its auditors guidance on determining whether FAR and Defense Federal Acquisition Regulation Supplement (DFARS) cost principles amount to "expressly unallowable costs" through Memorandums for Regional Directors (MRD). Contractors also 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," although with the 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, despite stating that the list contains those "expressly unallowable costs," DCAA's 2014 MRD included multiple FAR and DFARS cost principles that did not include costs "specifically named or stated to be unallowable," such as certain lease costs under FAR 32.201-11(h)(1) (stating limits on an "allowable" cost rather than referring to a cost as "unallowable"). 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 Board's decisions that also expanded the scope beyond a plain reading of the term "express," contractors were left without clear direction.

The May 2019 MRD, which "supersedes" the prior guidance, addresses the most glaring discrepancies between the earlier guidance and case law and the language of the FAR. The new guidance deletes the explanation from the 2015 MRD for how DCAA auditors should determine whether an unallowable cost may still be "expressly unallowable" even if it is not expressly stated in the FAR. The 2019 MRD also deletes all references to *Emerson Electric Co.*, ASBCA No. 30090, 87-1 BCA ¶19,478 (Nov. 19, 1986), which was cited as a basis for finding implicit "expressly unallowable costs" in previous MRDs. In *Emerson*, the Board 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. DCAA's previous MRDs referred extensively to *Emerson* to justify listing many cost principles as "expressly unallowable." These 2019 MRD changes in approach thus sharply contrast the previous MRDs.

The 2019 MRD also cut DCAA's list of presumptively expressly unallowable cost principles from 110 to 91. But the updated guidance leaves FAR 31.205-22 on the list in its entirety. The MRD, however, revised the "notes" regarding certain cost principles, including FAR 31.205-22. For example, the new MRD notes incorporate the two *Raytheon* lobbying cost decisions from the Board discussed above. The notes reflect these contradictory decisions by drawing the same distinction as the Board for when costs are expressly unallowable: bonus and incentive compensation costs versus salaries.

Conclusion

Wiley Rein has extensive experience in 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 should come as a welcome relief to contractors which will have more certainty on how DCAA intends to treat "expressly unallowable costs." 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. 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.

[1] FAR 31.201-6(e)(2): "Salary expenses of 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, provided the costs are material in accordance with subparagraph (e)(1) above (except when such salary expenses are, themselves, unallowable)."

George Petel is an associate in the Wiley Rein Government Contracts practice and works with election law attorneys on related matters.