Why Unallowable Cost Analysis Matters for Government Contract Compliance

Understanding Unallowable Costs in Government Contracting

Working with government contracts brings a level of scrutiny that commercial work rarely demands. One area that catches many contractors off guard is the classification of costs as unallowable. When you submit a cost proposal or an indirect cost rate, the government expects every dollar to be both allocable and reasonable. If a cost fails either test, it becomes unallowable. That means the government will not reimburse it, and including it can lead to penalties, disallowed overhead, or even contract termination.

I have seen companies lose millions simply because they lacked a proper unallowable cost analysis framework. They treated all expenses as normal business costs and assumed the government would pay. The reality is far stricter. The Federal Acquisition Regulation (FAR) Part 31 outlines specific categories of unallowable costs, including advertising, public relations, alcohol, entertainment, fines, and certain legal fees. But the list is not exhaustive. Auditors also look at whether costs are reasonable and necessary for contract performance. That judgment call is where the real challenge lies.

Common Pitfalls Without a Systematic Approach

Without a systematic way to identify and segregate unallowable costs, companies often make mistakes that compound over time. A typical scenario: an accounting department codes all marketing expenses as general overhead. The company later submits its indirect cost rate proposal, and during the audit, the government disallows a large portion of those marketing costs. The company then has to refund the money, plus interest. Worse, the disallowed costs may affect future rate negotiations, creating a cycle of reduced recovery.

Another common pitfall is mixing personal expenses with contract costs. I once worked with a small defense contractor whose owner used a company credit card for personal travel. They booked all charges as travel costs without separating personal meals, entertainment, or lodging upgrades. The government auditor flagged the entire travel account as suspect. The company had to reconstruct two years of expenses, which took months and cost tens of thousands in consulting fees.

These examples show why an ongoing unallowable cost analysis is not optional. It is a compliance necessity. The earlier you catch an unallowable cost, the easier it is to remove or adjust it before it reaches a proposal or a billing system.

What Makes a Cost Unallowable?

The FAR lists several categories of unallowable costs, but the interpretation often depends on context. For instance, advertising costs are generally unallowable unless they are specifically required by the contract. Public relations costs, such as lobbying or image campaigns, are also unallowable. But what about a booth at a trade show where you are also meeting with government clients? That can become a gray area. The key is to examine the purpose of the expense. If the primary benefit is to promote the company rather than to perform the contract, it is likely unallowable.

Interest on borrowed capital is another tricky area. The FAR explicitly states that interest on borrowings is unallowable, even if the borrowing was necessary to perform the contract. Many contractors assume that because the interest is a cost of doing business, it should be reimbursable. It is not. The government expects you to absorb financing costs from your own working capital or through other means.

Entertainment costs, including meals and tickets to events, are almost always unallowable. Some contractors try to argue that taking a government employee to lunch is a legitimate business development cost. But the FAR is clear: entertainment costs are unallowable regardless of their purpose. The only exception is if the contract specifically allows for such costs, which is rare.

Building a Practical Compliance Process

An effective unallowable cost analysis starts with clear policies and training. Everyone in the organization who approves or codes expenses needs to understand the basic rules. I recommend creating a simple checklist that flags common unallowable categories. For example, any expense coded as advertising, entertainment, fines, or interest should trigger a review by a compliance specialist or a cost accountant.

Software can help streamline this process. A good system can automatically flag potential unallowable costs during data entry and route them for approval. It can also maintain a database of past determinations, so you do not have to re-research the same issue every time. Over time, the system builds institutional knowledge. New employees can learn from the decisions made before them.

But software is not a silver bullet. The human element remains critical. An auditor will want to see that your company exercised judgment, not just that a checkbox was ticked. That means your unallowable cost analysis should include narrative explanations for why a cost was deemed allowable or unallowable. If you ever face an audit, those notes can be your best defense.

Real-World Example: A Costly Oversight

I recall a mid-sized manufacturing firm that supplied components for a defense program. They routinely expensed travel for their CEO, who often visited subcontractors and attended industry conferences. The company treated all those trips as direct contract costs. During a DCAA audit, the auditor questioned several trips where the CEO combined contract business with personal vacation days. The company had not separated the costs. The auditor disallowed the entire travel category for that period, totaling over $200,000. The company had to repay the government, plus interest, and it damaged their reputation for reliable cost accounting.

Had they performed a proper unallowable cost analysis at the time of each trip, they could have identified the personal portion and removed it from their billings. That simple step would have saved them a massive headache and a lot of money.

Segregating Costs in Practice

One practical method for handling unallowable costs is to create separate general ledger accounts for each category. For example, have a specific account for unallowable advertising, another for unallowable entertainment, and so on. When an expense comes in, your accounting team codes it directly to the unallowable account. That way, those costs never enter your indirect cost pool or your billing system. They are isolated from the start.

Another approach is to use a shadow allocation system. Under this method, you run your regular cost allocation as usual, but then you apply a percentage of unallowable costs to each contract based on a reasonable allocation base. The government often accepts this method if you can show it is consistent and auditable. But it requires solid documentation and periodic verification.

The Role of Software in Streamlining Compliance

Modern cost management software can automate much of the unallowable cost analysis. It can scan expense reports, purchase orders, and invoices for keywords or categories that are typical red flags. It can also enforce approval workflows so that any flagged item must be reviewed by someone with compliance training. Some tools even integrate with the FAR clauses to provide guidance on specific cost types.

But remember: the software is only as good as the rules you feed it. If your coding structure is sloppy or your training is weak, the software will still produce unreliable results. Invest time in setting up your cost structure correctly from the beginning. That investment pays off many times over during an audit.

Final Thoughts on Staying Compliant

Government contracting demands a higher standard of cost accountability. Unallowable cost analysis is not a one-time exercise but an ongoing discipline. It requires clear policies, consistent training, and a system that catches errors early. The companies that do it well treat it as part of their everyday operations, not as a special project before an audit. They build a culture of compliance where every person who touches a cost understands the rules.

If you are new to government contracting, start by reviewing the FAR Part 31 and your contract terms. Talk to your accounting team and your legal counsel. Consider running a mock audit to see where your current process might fall short. The goal is to find problems before the government does. That is the real value of a thorough unallowable cost analysis. It protects your revenue, your reputation, and your ability to win future contracts.