

SELECTED AREAS OF COST

Chapter 27 Fines, Penalties & Mischarging Costs

Authoritative Sources

[FAR 31.201-3](#) Determining Reasonableness

[FAR 31.201-4](#) Determining Allocability

[FAR 31.204](#) Application of Principles and Procedures

[FAR 31.205-15](#) Fines, Penalties, and Mischarging Costs

General Audit Guidelines

This chapter provides general audit guidelines for reviewing fines, penalties, and mischarging costs. In general, fines and penalties are forms of punishment or are levied in order to serve a deterrent function. Penalties do not include restitution, reimbursement, or compensatory damages (FAR 31.205-47(a)). Mischarging costs are costs incurred due to the contractor's inappropriate behavior or unreasonable acts.

This chapter addresses the following topics:

- 27-1 General Matters Concerning Fines, Penalties, and Mischarging Costs
- 27-2 Allowability of Fines and Penalties
- 27-3 Allowability of Mischarging

27-1 General Matters Concerning Fines, Penalties, and Mischarging Costs

Fines, Penalties, and Mischarging Costs can be associated with many activities of the contractor and are often combined with several types of cost. In addition, fines and penalties can be associated with and included in several elements of cost including employment related, legal, environmental, taxes, and banking. The variable nature of fines and penalties requires the auditor to use critical thinking skills when applying the criteria in the cost principle. The auditor should also consider whether the costs are allowable based on the "similar or related costs" concept in FAR 31.204(d) with reference to FAR 31.205-15. FAR 31.204(d) provides that the determination of allowability shall be based on the guidance contained in the subsection that most specifically deals with the cost at issue. For example, civil court monetary judgments or civil jury awards, expressly identified as punitive damages, can be similar to the penalties resulting from contractor violations of Federal, State, local, or foreign laws and regulations, which are expressly unallowable under FAR 31.205-15. Lastly, the auditor should consider reasonableness under FAR 31.201-3, Determining Reasonableness, and allocability under FAR 31.201-4, Determining Allocability, and applicable Cost Accounting Standards.

A key concept for the auditor to consider is the intent behind FAR 31.205-15, which is to prevent contractors from recovering fines, penalties, and costs associated with mischarging due to the contractor's inappropriate behavior or unreasonable acts.

27-2 Allowability of Fines and Penalties

The cost principle at FAR 31.205-15(a) makes costs of fines and penalties resulting from violations of, or failure of the contractor to comply with, Federal, State, local, or foreign laws and regulations unallowable, except when incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer. While punitive damages that are awarded in civil cases appear to be similar to the penalties identified in this cost principle, they do not constitute a penalty unless the punitive damages:

- (1) are unrelated to the amount of actual harm suffered and are related more to the penalized party's conduct;
- (2) are the proceeds from infractions that are collected by the state rather than paid to the individual harmed; **and**
- (3) result from a lawsuit that is based on a statute or regulation that was meant to address harm to the public rather than provide a remedy to the plaintiff.

Punitive damages will normally not meet all of these criteria and therefore are not typically unallowable under this cost principle. See discussion of the *Ingalls Shipbuilding v. Dalton*, 119 F.3d 972 (Fed. Cir. 1997) case below.

Audit Considerations:

Some auditor judgment is often required in the application of cost principle criteria. The allowability of fine and penalty costs usually depends on whether or not the costs were associated with good faith efforts to comply with laws and regulations or obvious acts of noncompliance. In many cases, the auditor will need to determine the reasonableness of the contractor's actions, which caused the fine or penalty.

A number of different employment-related proceedings or similar situations can lead to settlements that may involve fines and penalties (see Chapter 39, Labor Settlement and Strike Period Costs, and Chapter 41, Legal and Other Proceedings, for examples). Settlement awards, which may be paid to avoid proceedings (especially for employment-related issues) or may be directed by those proceedings, can be for compensatory damages, punitive damages, underpayment for work performed, and/or backpay. In other words, a settlement may include one or more of these types of cost and include fines or penalties. What constitutes a fine or a penalty can be difficult to determine, although the courts have addressed this issue. The Federal Circuit Court of Appeals in *Ingalls Shipbuilding v. Dalton*, 119 F.3d 972 (Fed. Cir. 1997) established the three numbered attributes shown above under the

Audit Considerations:

opening paragraph of this section. Claimed costs for payments, or a portion thereof, should be considered a penalty if the contractor's supporting documentation for the payment discloses that all of the *Ingalls* case attributes of a penalty are met.

Typically, these settlement payments combine several aspects of the case and only a portion of the settlement payment may be considered a penalty. The auditor will need to review the documentation, consider the attributes listed above, and determine what portion of the payment represents an unallowable fine or penalty, if any. It is also important for the auditor to consider additional aspects of settlements as described in Chapter 41, Legal and Other Proceedings, specifically section 41-4 of that chapter.

As discussed above, fines and penalties can take many forms. Another example includes penalties imposed by Government agencies for violation of department rules, regulations, and statutory requirements. For example, the State Department has levied a charge against contractors for violating the Arms Export Control Act and the International Traffic in Arms Regulations. These charges are expressly unallowable in accordance with FAR 31.205-15(a).

27-3 Allowability of Mischarging

The cost principle at FAR 31.205-15(b) states that costs incurred in connection with, or related to, the mischarging of costs on Government contracts are unallowable when the costs are caused by, or result from, alteration or destruction of records, or other false or improper charging or recording of costs. Such costs include those incurred to measure or otherwise determine the magnitude of the improper charging, and costs incurred to remedy or correct the mischarging, such as costs to rescreen and reconstruct records.

Audit Considerations:

As with fines and penalties, the determination that costs related to mischarging of costs are unallowable usually depends on whether or not the mischarged costs were associated with "honest mistakes", i.e. noncompliances, despite good faith efforts to comply with laws and regulations versus intentional mischarging.

The auditor will need to distinguish between routine self-governance activities, including corrections of honest mistakes, versus correction of intentional mischarging. Allowable self-governance activities are contractor efforts to develop and maintain effective internal controls and ethics programs to prevent and detect errors and irregularities, such as intentional mischarging. Allowable self-governance/internal audit activities end when an intentional mischarge is identified and confirmed. Costs related to the subsequent efforts, such as investigating the

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causes for the mischarge in depth, measuring the amount of the mischarge, determining other adverse effects to the contractor, and correcting the mischarge are expressly unallowable under the cost principle.

In addition, the auditor must be alert to the context of “improper” in FAR 31.205-15(b), describes the unallowable costs as costs caused by, or resulting from, alternation or destruction of records, or other false or improper charging or recording of costs. Unallowable costs are the costs that are related to deliberate or intentional acts. Said another way, the word improper should be defined in the context of the cost principle wording and not the broad dictionary definition. It is not the intention of the cost principle to make routine self-governance activities and corrections of unintentional errors unallowable. In the end, the auditors will need to exercise judgment on whether the costs in their situation rise to the unallowable level intended by the cost principle. Charges that are determined to be unallowable in accordance with FAR 31.205-15(b) are expressly unallowable.

For example, if a contractor implements new accounting system software and initially experiences a significant amount of costs recorded to incorrect cost objectives, the effort to correct these records would not be considered unallowable unless the auditor had evidence that the contractor did not make a good faith effort to implement the new software correctly. In other words, the cause of the effort to correct the records did not result from improper or intentional actions unless the auditor has evidence to indicate the contractor acted improperly when implementing the new system. On the other hand, if a contractor makes a voluntary disclosure that its employees intentionally falsified their timekeeping records, the effort associated with making the voluntary disclosure and correcting the records would be unallowable. The effort to investigate and determine whether intentional falsifications actually happened does not fall within the definition of unallowable cost per the cost principle.

In addition to evaluating mischarging related costs for compliance with the cost principle, the auditor should review the contractor’s policy for recording costs associated with mischarging to ensure the policy requires proper delineation between the allowable and unallowable effort described above. If the policy does not contain sufficient instruction to contractor employees for properly charging their mischarging related time, the FAO should consider reporting a system noncompliance on the accounting system.

Lastly, the auditor should still consider whether the costs for the correction of records are reasonable per FAR 31.201-3 and allocated correctly per FAR 31.201-4 and applicable Cost Accounting Standards.