



MTS SYSTEMS CORPORATION – Procedure

TITLE:

Unallowable Costs

NUMBER:

FIN-012.01

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1

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1.0 Purpose

The purpose of this procedure is to provide MTS Employees with information and guidance regarding compliance with statutory and regulatory requirements for properly identifying and excluding unallowable costs and ensuring that they are not charged to U.S. Government contracts and subcontracts (“contracts”). Failure to comply may result in MTS being subject to fines, penalties and other sanctions under the False Claims Act (FCA), and other statutes and regulations.

2.0 Scope

- 2.1 The provisions of this procedure shall apply to MTS Systems Corporation (“MTS”) officers and employees (“MTS Employees”) performing work on or in support of Federal contracts.
- 2.2 MTS Employees are responsible for understanding this procedure and ensuring its uniform and effective implementation, as well as ensuring that their conduct and actions are wholly consistent with its requirements, including referenced policies and procedures.
- 2.3 MTS is committed to maintain and consistently apply procedures to comply with all U.S. Government statutory and regulatory requirements related to classification of costs charged as either “allowable” or “unallowable” and to ensure that no costs identified as “unallowable” under the Federal Acquisition Regulations (“FAR”) Part 31, Cost Principles, are charged to U.S. Government contracts. MTS personnel are responsible for reading, understanding and consistently following these requirements, including referenced policies and procedures.
- 2.4 Government regulations and statutes such as Federal Acquisition Regulation (FAR), agency-specific FAR supplements, act and other agency related regulation or legislation may be referenced and are not included as full text in this document.
- 2.5 MTS undertakes to segregate and exclude unallowable costs from price quotations, based on company guidance as prescribed in Corporate Procedure *FIN-507 U.S. Government Bid Rates*.

3.0 Definitions

“Directly Associated Cost” - Any cost which is generated solely as a result of the incurrence of another cost, and which would not have been incurred had the other cost not been incurred.

“Expressly Unallowable” - 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.

“Federal Acquisition Regulation (FAR)” - The FAR provides for uniform policies and procedures for acquisition by all executive agencies. Individual agency acquisition regulations implement or supplement the FAR, such as the Department of Defense Supplement, the DFARs.



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“Non-billable Cost” - A cost that is first an “allowable cost” as determined by the FAR and secondly a cost that falls outside of the limits allowed by a specific contract; therefore, the cost is not billable to the US Federal Government.

“Unallowable Cost” - Any cost which, under the provisions of any pertinent law, regulation, or contract, cannot be included in prices, cost reimbursements, or settlements under a Government contract to which it would otherwise be allocable.

4.0 Policy

MTS Systems Corporation is committed to classifying business expenses incurred by the Company as “allowable or unallowable”, as defined in the Federal acquisition Regulations (FAR) Part 31, Cost Principles. MTS undertakes procedures and controls to ensure that unallowable costs are not included in prices quoted, billings or costs charged to U.S. Government contracts and subcontracts. The Corporate Finance function is responsible for establishing procedures for proper classification and assurance that unallowable expenses are excluded from U.S. Government contract.

5.0 Procedure

5.1 Applicability of Unallowable Costs Based on Contract Types

5.1.1 The FAR cost principles identify unallowable costs applicable to the following types of contracts or contract-related transactions:

- a. Pricing of fixed-price contracts and modifications whenever a cost analysis is required under FAR Part 15;
- b. Determination or negotiation of costs under a fixed-price contract;
- c. Determining reimbursable cost under a cost reimbursement contract;
- d. Negotiating indirect cost rates, including those for interim and progress payments;
- e. Proposing, negotiating or determining cost where the contract has been terminated;
- f. Re-determining the price under a price-redetermination contract;
- g. Revising the price of a fixed-price incentive contract;
- h. Pricing changes and contract modifications;
- i. Other T&M; and
- j. Flexibly-priced contract not covered by the above.

5.1.2 The FAR Cost Principles do not apply to firm fixed-price contracts awarded under sealed bid procedures or procedures involving adequate price competition. These principles, however, do apply to modifications to such contracts.



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5.2 Allowable Cost (FAR 31.201-2)

5.2.1 Pursuant to FAR Part 31.201-2, a cost is allowable only when the cost complies with all of the following requirements:

- a. The cost must be reasonable;
- b. The cost must be allocable to the contract;
- c. The cost must be allocated to the contract in accordance with Cost Accounting Standards, if applicable; otherwise, generally accepted accounting principles and practices;
- d. The cost must be in accordance with the terms of the contract; and
- e. The cost must not be unallowable pursuant to FAR 31.

5.2.2 A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business. A cost is not reasonable simply because it was incurred. If the government challenges a specific cost, it is MTS' responsibility to prove that the cost is reasonable. Reasonableness is dependent on a variety of considerations and circumstances, including:

- a. The ability of the contractor to prove that type of cost is generally recognized as ordinary and necessary for the conduct of the business or the contract performance;
- b. Generally accepted sound business practices, arm's-length bargaining, and Federal and State laws and regulations;
- c. The company's responsibilities to the government, other customers, the owners of the business, employees, and the public at large;
- d. The circumstances of a transaction should not deviate significantly from the Company's established business practices.

5.2.3 A cost is allocable if it is assignable or chargeable to one or more cost objective (e.g., contract or project) on the basis of the relative benefits received or other equitable relationship. A cost is allocable to a government contract if it is incurred specifically for the contract, benefits both the contract and other work (and can be distributed to them in reasonable proportion to the benefits received), or is necessary to the overall operation of the business even if it is not directly chargeable.

5.2.4 Specific contract terms and/or advanced agreements can impact the treatment of certain costs. Employees should be mindful of their existence and consult contract briefs to ensure compliance with all applicable terms and conditions.

5.3 Accounting for Unallowable Costs



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- 5.3.1** The Government Accounting group is responsible for identifying expressly and other unallowable costs, including any directly associated cost, and to exclude these costs from any billing, claim, or proposal to which the FAR Cost Principles apply (refer to Section 5.1.1 for a listing of the types of contracts or contract-related transactions upon which the FAR cost principles apply).
- 5.3.2** The FAR Cost Principles generally divide costs into three broad categories:
- a. Costs that are expressly unallowable (for example: bad debts, fines and penalties, entertainment costs, interest and financial costs, executive lobbying costs and the cost of alcoholic beverages;
 - b. Costs that are generally allowable (for example: trade, business, technical and professional activities); and
 - c. Costs that are partially allowable (for example: travel costs, costs related to legal proceedings, and employee health, morale, and welfare costs).
- 5.3.3** In some circumstances, more than one cost principle covering allowability under FAR 31.205 will apply to a specific cost. In such instances, guidance should be obtained from the Government Accounting group to determine how such cost should be treated. Classification of a cost should be made prior to the time the cost is incurred, when possible, in order to properly identify the nature of the cost, and charge the cost to the correct cost account.
- 5.3.4** MTS shall establish accounts within the SAP Chart of Accounts to segregate and capture unallowable costs. These accounts will typically be included in the 9xxxxx account range and selectively within the 7xxxxx account range. These accounts shall be excluded from claims on U.S. Government contracts.
- 5.3.5** Corporate Procedure *FIN-507 U.S. Government Bid Rates* defines the process for planning accurate and reliable bid rates, indirect expense rates, and base factors that provide for the recovery of allowable costs on government contracts and subcontracts in compliance with the Federal Acquisition Regulation (FAR) and provides for a consistent estimating practice.
- 5.3.6** Annually, all Test and Corporate employees and contractors in the U.S. must complete Unallowable Cost training. Refer to the Corporate Procedure *FIN-006.01 Labor Charging Procedure*, Corporate Procedure *FIN-008.01 Corporate Travel and Expense Reimbursement*, and Corporate Policy *FIN-201 Accounts Payable* for specifics on the treatment of unallowable costs.
- 5.3.7** FAR Part 31.205 identifies 52 specific items of cost and discusses the treatment of these costs for government purposes. Refer to Appendix A as a reference tool in making an initial assessment as to whether a particular cost category is an allowable or unallowable cost.

5.4 Indirect Rate Agreements



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5.4.1 The Government Accounting group must accurately classify unallowable costs and ensure that these costs are not being included for purposes of Indirect Rate calculations and agreements pursuant to FAR Part 42.7, Indirect Cost Rates. The Government Accounting group shall take reasonable steps to properly code and segregate unallowable costs. Refer to the Corporate Procedure *FIN-507 U.S. Government Bid Rates* for the process for calculating indirect expense rates that provide for the recovery of allowable costs on government contracts and subcontracts in compliance with the Federal Acquisition Regulation (FAR).

5.5 Compensation

5.5.1 The Government Accounting group in conjunction with Human Resources is responsible for ensuring that compensation is allowable pursuant to FAR Part 31.205-6.

5.5.2 On an annual basis, the Government Accounting group will ensure that compensation of a senior executive in excess of the benchmark compensation amount determined applicable for the contractor's fiscal year by the Administrator, Office of Federal Procurement Policy (OFPP), under Section 39 of the OFPP Act (41 U.S.C. 435) is segregated at year-end. The U.S. Office of Personnel Management provides the current executive salary limits at http://www.whitehouse.gov/omb/procurement_index_exec_comp. Refer to Corporate Procedure *FIN-507 Government Bid Rates* for the process for calculating indirect expense rates that provide for the recovery of allowable costs on government contracts and subcontracts in compliance with the Federal Acquisition Regulation (FAR).

5.5.3 Backpay, as defined in FAR Part 31.206-6, is a retroactive adjustment of a prior years' salaries or wages. Backpay is an allowable cost if it occurs under any of the following conditions.

- a. Payments made to employees resulting from underpaid work actually performed, if required by a negotiated settlement, order, or court decree.
- b. Payments to union employees for the difference in their past and current wage rates for working without a contract or labor agreement during labor management negotiation.
- c. Payments to nonunion employees based upon results of union agreement negotiation if:
 - i. A formal agreement or understanding exists between management and the employees concerning these payments; or
 - ii. An established policy or practice exists and is followed by the contractor so consistently as to imply, in effect, an agreement to make such payments.

Backpay that does not meet any of the above conditions is an unallowable cost.

5.6 Cost Proposals

5.6.1 Both the Sales and Contract Management departments are responsible for reviewing cost proposals prior to submission to the government. Additionally, the Senior Government



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Accountant is responsible for reviewing cost proposals for contracts that meet the Truth in Negotiation Act (TINA) threshold. A thorough review should be conducted to ensure that unallowable costs have been excluded from cost calculations. Refer to the Corporate Procedure *FIN-010.01 U.S. Government Estimating* for the process for planning accurate and reliable bid rates, indirect expense rates, and base factors that provide for the recovery of allowable costs on government contracts and subcontracts in compliance with the Federal Acquisition Regulation (FAR).

5.7 Internal Reporting of Suspected Violations of MTS policy/procedure or any Federal Criminal Law

5.7.1 As a Federal contractor, MTS will comply with the regulations set forth in FAR 3.10 and 52.203-13 including the requirement to “timely disclose, in writing, to the agency Office of the Inspector General (OIG), with a copy to the Contracting Officer, whenever, in connection with the award, performance, or closeout of this contract or any subcontract there under, the Contractor has credible evidence that a principal, employee, agent, or subcontractor of the Contractor has committed” the following:

- a. A violation of Federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations found in Title 18 of the United States Code; or
- b. A violation of the civil False Claims Act

5.8 Corrective / Disciplinary Action

5.8.1 MTS will take prompt and appropriate corrective action to address any violations of this procedure. Disciplinary action will be taken against MTS Employees whose actions are found to violate this procedure or who fail to reasonably detect or report such violations or who retaliate against others who report such violations. Refer to *MTS Code of Conduct* for further detail regarding the process of reporting suspected violations of MTS policy/procedure or Federal laws.

5.9 Duty to Remain Current with Laws

5.9.1 Laws, regulations and contractual requirements are subject to change, which could require revision to this procedure. MTS employees shall remain current with any such changes and shall comply with such changes, regardless of whether or not the change has been incorporated into any given version of the procedure. Any questions regarding conflicts with this procedure shall be addressed to the MTS Corporate Controller.

6.0 Policy Owner

Corporate Finance



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7.0 References

7.1 Corporate Finance Policies

- FIN-012 Unallowable Costs
- FIN-201 Accounts Payable
- FIN-507 U.S. Government Bid Rates

7.2 Corporate Finance Procedures

- FIN-006.01 Labor Charging Procedure
- FIN-008.01 Corporate Travel and Expense Reimbursement
- FIN-010.01 U.S. Government Estimating Procedure

7.3 Appendices

- Appendix A – FAR part 31 Unallowable Cost Matrix

7.4 Other

- www.dcaa.mil: DCAA performs all necessary contract audits for Department of Defense (DoD). Also provide contract audit services to other Government agencies as appropriate. FIN-006 MTS Labor Charging Procedure
- www.dcma.mil: Defense Contract Management Agency (DCMA) – DCMA is the DoD component that works directly with Defense suppliers to help ensure that DoD, Federal, and allied government supplies and services are delivered on time, at project cost, and meet all performance requirements. The individuals usually carry the title of “Contracting Officer.”
- www.dcaa.mil/cam.htm: DCAA Defense Contract Audit Agency Manual (DCAAM) – This manual prescribes DCAA auditing policies and procedures. It provides step-by-step audit information on all audits performed by DCAA such as:
 - Contractor Compliance with Billing Instructions
 - Annual Examination of Paid Vouchers
 - Audit of Contract Overpayments
 - Reconciliation of Recorded and Billed Costs (Unbilled Analysis)
 - Adjustment of Costs and Rates (Rate Adjustments)
- <http://farsite.hill.af.mil>: This address takes you to the Federal Acquisition Regulation (FAR) web page. You will find complete descriptions for any of the FAR clauses referenced in this manual.

REVISION HISTORY

Rev	Description of Change	Effective Date

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0	New	7/2/2012
1	Revisions primarily consist of: 1) adding backpay discussion in section 5.5.3; and 2) updating of section 5.3.6 to clarify who must complete unallowable cost training.	12/10/2013

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