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CHAPTER 7

7-000 Selected Areas Of Cost

7-001 Scope of Chapter

a. This chapter discusses items of cost and accounting methods requiring special attention. The guidance furnished is oriented toward audit methods and techniques and is not intended as a substitute for, or interpretation of, the Federal Acquisition Regulation.

b. Expenses which are questioned based on allowability, allocability and/or reasonableness criteria must reference the applicable FAR/DFARS, Part 31 (see 6-608.3).

c. If the contractor included expressly unallowable costs in the final indirect cost settlement proposal, the auditor should question the costs and recommend to the ACO that the costs be subject to the penalty provisions at FAR 42.709. Expressly unallowable costs are defined in FAR 31.001 (see 6-609.1e.). The term "expressly unallowable costs," as it is used in the penalty regulation, includes only those costs that are expressly unallowable under FAR 31.205 or applicable agency supplement.

7-100 Section 1 --- Computer Cost Allocation (Algorithm)

7-101 Introduction

This section contains guidance for evaluating the accounting for computer programming and reprogramming costs and computer operating costs.

7-102 Allocation of Computer Operating Costs

7-102.1 General Principles

a. DCAA policy requires that where computer costs are material, the FAO audit staff should develop an understanding of computer cost composition and test the contractor's use of the criteria sufficiently to assure that costs are distributed in an equitable manner. If an algorithm is used, and costs distributed are significant, periodic audit evaluation of the algorithm is essential.

b. This coverage addresses a common situation where a contractor has a computer system designed to be responsive to only the internal needs of the organization. Adjustments will have to be made to the audit program to handle the other types of computer system environments which the auditor may encounter. Adjustments should be made on a case by case basis.

c. This section primarily addresses billing algorithms. However, many of our contractors distribute IT costs through general indirect cost allocations. In those cases auditors must still determine whether methods used to distribute IT costs are equitable. While algorithms based on resource utilization are generally preferable, an algorithm is not required if indirect cost distribution is equitable.

d. Cost Accounting Standard 418 as related to computer costs provides for consistent determination of direct and indirect costs. It provides criteria for the accumulation of indirect costs including service center and overhead costs in indirect cost pools and provides guidance on selection of allocation measures based on the beneficial or causal relationships between an indirect cost pool and cost objectives. Refer to CAS 418 (8-418) for additional details.

e. Billing algorithms used by contractors to allocate computer costs should be included in a contractor's disclosure statement in order for the disclosure statement to be considered adequate (see 8-206).

7-102.2 Algorithm Development

a. A computer billing algorithm is a mathematical formula used to develop the amount to be charged a customer, contract or overhead pool for services. The formula is based on such factors as type of equipment used, storage media utilization and space allocation, type of processing, response or turnaround time, and time of day services are provided. In a complex IT environment, a wide range of IT support is provided to various system users. Developing an algorithm to equitably distribute IT costs may incorporate all major IT resources or only a few. The greater the variation in types of application or services provided, the greater the need for a more complex algorithm. The cost of developing a complex algorithm, including subsequent recording of computer use through internal software, is normally compared with the benefit (exactness) of such an algorithm. If it can be demonstrated that an algorithm using only two or three resources is equitable, a complex algorithm is not necessary.

b. Resources typically measured and collected for construction of a user charge include:

--- Central processor (CPU) time - the amount of CPU time required to accomplish a specific task.

--- Computer memory requirements - many algorithms consider the amount of memory (bytes) used for each job.

--- Input/output transactions - with the wide range of data input/output devices such as magnetic tape, disks, and terminals, algorithms often consider the number of times such equipment is accessed.

--- Direct access storage requirements - tape and disk storage requirements are often considered, including the amount of disk workspace and number of tape devices and/or tape mounts required by each job.

c. Typically, accounting information is collected by operating system software for each user application. In addition, the operating system usually contains provisions for user-supplied routines to collect utilization data. Numerous software vendors have developed specialized software packages to reduce these data and generate a variety of management reports. Such packages often provide time-sequenced resource utilization statistics that can be used to develop billing criteria and make recommendations on improving overall system efficiency.

d. Billing information is usually generated by a billing algorithm. Often the final billing unit is an average resource unit incorporating the various algorithm components. A simple example is shown below:

Resource unit = CPU time X coefficient
+ Memory usage X coefficient
+ Input/output transactions X coefficient
+ Printer time X coefficient

e. The coefficients, which include but are not limited to staff costs, programming costs, and hardware costs, should be evaluated for applicability. Most often, coefficients reflect a ratio between the cost of a specific resource and the total availability of the resource (for example, cost of CPU divided by total available CPU seconds.)

7-102.3 Audit Objectives in Algorithm Evaluation

When evaluating computer billing algorithms, audit objectives include:

a. Developing an overall understanding of allocation methods used.

b. Verifying that algorithm components accurately represent resources used.

c. Validating that there are sufficient controls to assure that billings are processed in an accurate and reliable manner.

d. Determining whether all applicable costs are included in the development of the coefficients.

e. Validating that the individual rates or coefficients are accurate and properly applied.

f. Testing allocation criteria to assure that computer cost allocations are equitable.

7-102.4 Algorithm Review Techniques

For purposes of algorithm evaluation, a structured audit approach is suggested as outlined in the following subparagraphs. A billing algorithm summary checklist, as shown in Figure 7-1-1, is often useful to control necessary audit steps.

a. Determine billing formula risk and materiality. If billing algorithms do not distribute a material amount of contract cost

(direct and/or indirect), the need for a detailed algorithm review may be obviated.

b. Request contractor support for the billing formula:

(1) Explanation of the algorithm. Generally the contractor should have documented the algorithm. Consideration should be given to any tests (benchmarks) performed to validate the algorithm.

(2) IT resources used in the algorithm. The contractor should be able to identify which resources have been included in the formula and the rationale, if applicable, for excluding major resources.

(3) Cost distributed during recent periods.

(4) Accounting treatment of variances. This is a critical area as the timing of variance adjustments and accounting treatment can significantly impact costs distributed to contracts.

(5) Current inventory of IT equipment. This will be valuable when determining whether all appropriate resources are included in the algorithm. In addition, it is essential for adequate equipment maintenance and control that the contractor have detailed visibility of IT resources.

c. Compare billed IT costs with actual:

(1) Are procedures established for equitable and timely treatment of identified variances?

(2) If there are significant recent variances, has the algorithm been adjusted for more accurate cost distribution?

(3) Does the contractor compare costs for periodic runs of the same job; for example, payroll? Are significant differences investigated?

(4) Does the contractor make periodic revisions to projected rates as a result of changes in estimated costs or usage of a component?

(5) Are discounted coefficients offered for off-hours usage?

(6) Has an evaluation been made of the contractor's previous projections of computer component rates by comparison of actual rates to projected rates? What are the reasons for significant variances such as unplanned usage or nonusage, or the increase or decrease in costs? If the contractor makes periodic reviews of projected rates, arrange to audit these reviews. If there have been significant variances due to volume differences, perhaps more frequent reviews should be recommended.

d. Verify major IT resources. Critical considerations for an algorithm are whether it is based on verifiable usage data, and whether resources used in the algorithm accurately represent services provided system users. Consider whether:

(1) All major resources are included in the algorithm.

(2) Resource usage is based on verifiable data.

(3) Resources are costed appropriately.

(4) Algorithm components are restricted to IT resources.

(5) Lease agreements for equipment have been considered.

(6) Equipment costs are properly determined for each grouping.

(7) The algorithm includes any unallowable costs, such as excessive rental charges for IT.

e. Evaluate coefficients and other factors:

(1) Are coefficients based on verifiable data?

(2) If there are outside sales of IT services, are the services comparable to in-house applications and are they priced comparably to in-house IT support?

f. Manually compute the billing formula for selected major government projects:

(1) Can the algorithm be computed using verifiable data?

(2) Is the manual calculation reconcilable to the machine output?

(3) Can coefficients and factor utilization be accurately verified?

(4) Are comparisons of items such as the ratio of cost input to IT billings reasonable?

Figure 7-1-1 (Ref.7-102.4)
Billing Algorithm Summary Checklist

Audit Step	Working Papers Reference	Auditor	Date
1. Risk evaluation			
2. Contractor support			
a. Obtain explanation of algorithm			
b. List IT resources in algorithm			
c. List distributed IT costs by quarter			
d. Identify accounting treatment of variances			
e. Identify IT policies/procedures for cost treatment			
f. Obtain current inventory of all IT equipment			
3. Compare billed IT costs with actual			
a. Variance treatment			
b. Timing of adjustments			
c. Are fixed-price/commercial type variances substantial			
4. Verify IT inventory (consider sampling techniques)			
a. Purchase agreements			
b. Are major resources in algorithm?			
5. Evaluate coefficients and other factors – Are coefficients based on verifiable data?			
6. Manually compute billing formula for major government projects			
a. Is it based on available/verifiable data?			
b. Is the manual calculation reconcilable to machine form?			
c. Can coefficients/factors be verified?			
d. Are parity checks such as contribution to cost comparable?			

7-102.5 Billing Algorithm Example

a. When internal measurements are used, billing rates are developed to allocate the cost of each major component on the basis of the component's usage. These billing rates are usually computed annually and are developed by dividing the estimated annual cost associated with each component by the estimated annual usage of the component. The billing may be made in one of two ways: (1) separate billing rate for each component or (2) a single overall rate which is applied to equivalent units of usage for each component.

b. Computer costs can be distributed equitably using a wide range of mathematical techniques. As previously discussed, it is important that a contractor clearly document methods used, and base cost allocations on verifiable cost and utilization data.

c. The example in Figure 7-1-2 includes a five-resource cost allocation. For illustration purposes, one resource-magnetic tape drives-is traced through a weighting factor (coefficient) adjustment and the rate calculation. Coefficients are not essential but are included in many algorithms. Accordingly, a typical coefficient is included in the example.

Figure 7-1-2
Billing Algorithm Example

1. Formula resource components are:

Resource Allocated	Unit of Measure	Charge/Prime Shift
CPU	CPU hours	$300/hr
Memory	1024 work block hours	$5/hr
Disk Channel Time	Channel hours	$25/hr
Tape Channel Time	Channel hours	$10/hr
7- and 9-track Tape Drives	Elapsed hours	$5/hr

2. The coefficient is computed using the following algorithm:

CWF = computer weighting factor or coefficient to equalize billings.
Cost r = cost of resources being allocated
T Cost = total IT costs to be allocated
Total r = number of resource units available
% used = percent resources are used

3. If we want to illustrate the weighting factor for tape drive utilization, we can assume the following data was available in contractor records.

Cost r = $12,500
T Cost = $3,000,000
Total r = 16 tape drives
% used = 70%

4. Substitute into the algorithm:

Figure 7-1-2

5. After developing an application weighting factor (coefficient), a rate is normally developed for the resource. Again for illustration purposes.

6. If contractor records show:

Cost r = $12,500		
Max r (prime shift) 16 tape drives		
X 40 hrs/wk X 52 wks	=	33,280
(second shift) 16 tape drives		
X 40 X 52 X 50% disc		16,640
		49,920

7. Substituting:

8. As shown above, manually calculating the rate for tape drives shows an actual rate of $5.43. If a billing rate of $5.00/hr is used and utilization forecasts are accurate, tape drive cost will be underabsorbed.

d. As billing algorithms vary widely, this example should not be viewed as typical. However, it does demonstrate potential algorithm complexity. Accordingly, the approach suggested in 7-102.4 provides a frame-work for developing an audit opinion without evaluating and testing each component of the algorithm. If each factor or algorithm component cannot be verified by historical or current data, risk that costs are unequitably distributed is greatly increased. In such cases, the audit report should recommend that billing algorithms be based on verifiable data and that they include major IT resources used.

e. In many instances contractors may simplify the billing process. The example below addresses CPU costs only (other resources would be billed similarly), and if estimated CPU utilization is reasonable, billed costs would be equitable.

Cost of CPU for billing period = $15,000
Available CPU seconds = 720,000

Billed amount = $.020833 X CPU seconds consumer for each job

7-103 Significant Nonrecurring Costs of Computer Programming and Reprogramming

7-103.1 General Principles

Equity in accounting for significant nonrecurring costs of computer programming and reprogramming usually requires that such costs be capitalized/amortized. The initial programming costs are incurred in order to place the computer into operation and as such are normally as much a part of the initial costs of the computer as are the equipment installation costs. A major change in either the equipment or the system usually involves the incurrence of significant reprogramming costs. These costs will normally benefit future periods in much the same manner as major modifications of the equipment. On the other hand, established programs are subject to minor refinements and improvements, the costs of which are chargeable to current operations in much the same manner as minor repairs.

7-103.2 Amount to Be Capitalized

The amount of programming or reprogramming costs to be capitalized should represent the actual costs incurred by the contractor in preparing and testing the program; that is, all applicable direct and indirect costs should be included up to the point the program becomes operational.

7-103.3 Amortization Period

The length of the amortization period should be established on the basis of the estimated number of years that will benefit from the incurrence of the programming or reprogramming costs. As a general rule the period of amortization of those programs for which there appears to be a continuing need should not exceed the anticipated useful life of the computer. A shorter amortization period should be used in those cases where the contractor can demonstrate by historical data or otherwise that the useful life of the program is shorter than that of the computer. At the larger computer centers, where numerous programs may be involved, an averaging of the expected lives of various programs may be acceptable when such procedure results in a reasonable amortization of the related programming costs over the years benefited.

7-103.4 Amortization Method

The method used to amortize the costs over the estimated useful life of the program should be based on the contractor's normal practice applicable to other items of software. Where this is not possible, any reasonable method of amortizing such costs over the estimated useful life of the program should be considered acceptable particularly if the method is the same as that used for depreciating the equipment.

7-103.5 Justification for Immediate Charging to Current Operations

In some circumstances, the contractor may represent that the desired objective of capitalization/amortization as outlined above is substantially and consistently achieved by charging to current operations all programming and reprogramming costs when and as they are incurred. Due consideration should be given to such representation, provided the contractor submits sufficient data in support of the representation.

7-104 Accounting for the Costs of Computer Software for Internal Use (SOP 98-1)

7-104.1 Applicability of SOP 98-1

On 4 March 1998, the Accounting Standards Executive Committee (AcSEC) of the AICPA issued Statement of Position (SOP) 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. In the absence of coverage in FAR, CAS, or other government regulations, Generally Accepted Accounting Principles will be used for contract costing purposes. All contractors, except state and local governments, will follow the provisions of SOP 98-1, effective for fiscal years beginning after December 15, 1998.

7-104.2 Major Requirements of SOP 98-1

a. Characteristics of Internal-Use Computer Software. SOP 98-1 defines internal-use software as software having both of the following characteristics:

- the software is acquired, internally-developed, or modified solely to meet the entity's internal needs; and
- during the software's development or modification, no substantive plan exists or is being developed to market the software externally.

b. Capitalize Versus Expense. SOP 98-1 stipulates that capitalization of costs should begin after both of the following have occurred: (1) management, with the relevant authority, authorizes (implicitly or explicitly) and commits to funding a computer software project and believes that it is probable that the project will be completed and the software will be used to perform the function intended; and (2) conceptual formulation, evaluation and selection of possible software project alternatives (referred to as the "preliminary project stage") have been completed. After completion of the preliminary project stage, the project proceeds to the "application development stage." Costs related to this stage are capitalized. The application development stage generally includes:

- Designing the chosen path, including software configuration and software interfaces;
- Coding;
- Installation to hardware; and
- Testing, including parallel processing phase.

The costs of data conversion from old to new systems, such as purging or cleansing of existing data, reconciliation or balancing of the old data and the data in the new system, creation of new/additional data, and conversion of old data to the new system, should be expensed. Costs to develop or obtain software that allows for access to or conversion of old data by new systems should be capitalized.

Capitalization should cease when a computer software project is substantially complete and ready for its intended use. Computer software is ready for its intended use after all substantial testing is completed. Costs incurred during the post-implementation/operation stage, such as maintenance and training costs, should be expensed as incurred. The SOP states that even if training cost is incurred during the application development stage, it should be expensed as incurred.

Costs of significant upgrades and enhancements to internal-use computer software should be capitalized if it is probable that those expenditures will result in significant additional functionality. Additional functionality is defined as changes to the software so that it may perform a task it is not currently able to perform.

c. Capitalizable Costs. The following costs incurred during the application development stage should be capitalized:

- External direct costs of materials and services consumed in developing or obtaining internal-use computer software, such as costs incurred to obtain computer software from third parties;
- Payroll and payroll-related costs for employees who are directly associated with and who devote time to the internal-use computer software project, to the extent of the time spent directly on the project.
- Interest costs incurred while developing internal-use computer software (See 7-104.3a).

d. Component Accounting. SOP 98-1 applies to the individual components or modules of the computer system. For each

component or module of a software project, amortization should begin when the component or module is ready for its intended use, even though the entire software system will not be completed until a later accounting period.

e. Amortization Method. SOP 98-1 provides that capitalized costs should be amortized over the useful life of the software on a straight-line basis unless another systemic and rational basis is more representative of the software's use. For example, accelerated methods of amortization may be appropriate when the utilization of the software is significantly greater in the earlier years of the useful life than the later years.

7-104.3 Audit Considerations

a. SOP 98-1 stipulates that interest should be capitalized in accordance with the provisions of FASB Statement No. 34, Capitalization of Interest Cost. FAR 31.205-10(b)(2) disallows actual interest cost in lieu of the calculated imputed cost of money for capital assets under construction, but allows cost of money computed in accordance with CAS 417 whether or not the contractor has contracts subject to CAS. However, the difference may not be material in most cases. Auditors should not take exception to contractor's capitalization of actual interest costs if the amount does not differ materially from the cost of money calculated in accordance with CAS 417.

b. SOP 98-1 provides that general and administrative (G&A) costs, overhead costs, and training costs should not be capitalized as costs of internal-use software -- those costs relate to the period in which they are incurred. The expensing of G&A and overhead costs allocable to capitalized projects conflicts with the fundamental requirements of CAS 410 and 418 that require such costs to be allocated to cost objectives, including capitalized projects. Auditors should first consider the materiality of G&A and overhead costs allocable to capitalized projects when addressing this issue. If the impact would be significant, the auditors should work with the contracting officer regarding how best to protect the government's interest without unduly burdening the contractor or the government.

c. At contractor locations where the government, in the past, has allowed the expensing of the costs of developing internal use software, special care must be taken to ensure the costs are not double recovered by the contractor (i.e., the costs expensed in prior periods are capitalized and amortized in the current and future periods). Further, contractors that previously expensed the costs of software developed or obtained for internal use will be required to change their accounting practices to comply with SOP 98-1. Contractors with CAS-covered contracts may be required to submit a revised disclosure statement in accordance with FAR 52.230-2(a)(2) (full CAS-coverage), 52.230-3(a)(3)(i) (modified CAS-coverage) and 52.230-5(a)(2) (educational institutions). Further, in accordance with FAR 52.230-6(a), the contractor may be required to provide the contracting officer the total potential impact of the change in accounting practice on contracts containing the CAS clause and a general dollar magnitude of the change.

7-105 Accounting for Costs Related to Enterprise Resource Planning (ERP) Systems

7-105.1 Introduction

Many contractors are investing significant resources in implementing Enterprise Resource Planning (ERP) systems to reengineer their business processes and to replace legacy systems that no longer meet their needs. A typical ERP project involves reengineering business processes and selecting and implementing commercially available software packages from the vendors such as SAP, Oracle, Deltek, etc. This section provides guidance on accounting treatment of cost related to ERP systems. (See 5-406.7 for guidance related to audit of ERP systems internal controls.)

7-105.2 Applicability of EITF Issue No. 97-13 and SOP 98-1

Financial Accounting Standards Board (FASB) Emerging Issue Task Force

(EITF) Issue No. 97-13, Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project that Combines Business Process Reengineering and Information Technology Transformation, dated November 20, 1997, addresses the issue of business process reengineering activities. EITF Issue No. 97-13 sets forth the typical activities of a business process reengineering project that is part of a broader software implementation project, such as an ERP project. It also incorporates the proposed AICPA Statement of Position (SOP) 98-1, Accounting for Costs of Computer Software Developed or Obtained for Internal Use, which was finalized on March 4, 1998, on internal-use software as guidance on accounting for the software elements of the information technologies transformation projects. The detailed audit guidance on SOP 98-1 is provided in 7-104. In the absence of specific coverage in FAR, CAS, or other government regulations, Generally Accepted Accounting Principles, including EITF Issue No. 97-13 and SOP 98-1, are the principles contractors must use in accounting for costs related to implementing ERP systems for contract costing purposes.

7-105.3 Business Process Reengineering (EITF Issue No. 97-13)

a. EITF Issue No. 97-13 provides that the cost of business process reengineering activities, whether performed internally or by third parties, is to be expensed as incurred. This also applies when the business reengineering activities are part of a project to acquire, develop, or implement internal-use software. The costs associated with the following business process reengineering activities should be expensed as incurred:

(1) Preparation of request for proposal.

(2) Current state assessment: The process of documenting the entity's current business process, except as it relates to current software structure. This activity is sometimes called mapping, developing an "as-is" baseline, flowcharting, or determining current business process structure.

(3) Process reengineering: The effort to reengineer the entity's business process to increase efficiency and effectiveness. This activity is sometimes called analysis, determining "best-in-class," profit/performance improvement development, or developing "should-be" processes.

(4) Restructuring the work force: The effort to determine what employee makeup is necessary to operate the reengineered business processes.

b. Because ERP projects combine internal-use software (governed by SOP 98-1) and business reengineering activities (governed by EITF 97-13), it is important to properly classify such activities. Some of the reengineering activities could be occurring concurrently with software implementation. For costs to be expensed as reengineering activities, the focus of the activities should be on process rather than software systems. This is true even if contractor employees, outside consultants, or software vendors involved in these activities may have information technology and software application expertise.

c. When an outside consultant or a software vendor is used to complete an ERP project, the total price of the contract may include multiple elements, such as business process reengineering, software costs, training, maintenance support, etc. EITF Issue No. 97-13 provides that the cost should be allocated to each element based on the relative fair values of those separate activities, not necessarily the separate prices stated within the contract for each element. This is important because some of these costs are required to be capitalized as discussed in 7-105.4 below. The information such as vendor price lists, price charged or quoted by similar vendors, or vendor pricing sheets (rates per hour times budgeted hours) can be used to determine the separate activity market prices. Auditors should ensure that the estimate of fair value assigned to each activity is reasonable and that contractors have adequate procedures to allocate the consulting costs between business reengineering activities and internal-use software development activities (i.e., preliminary, application development, and post-implementation).

7-105.4 Computer Software Developed or Obtained for Internal Use (SOP 98-1)

a. The software element of ERP projects should be accounted for in accordance with SOP 98-1. SOP 98-1 requires companies to capitalize and amortize many of the costs associated with developing or obtaining software for internal use. A typical ERP project encompasses a wide range of software related activities, such as software acquisition, configuration, modification, data conversion, maintenance, etc. Accounting treatment of those activities should be determined based on the criteria specified in SOP 98-1 as discussed in 7-104.

b. If a contractor has a software license and software maintenance contract from an ERP vendor, the software license costs are capitalized, while the software maintenance portion of the contract is expensed.

c. ERP systems generally involve several modules or components. SOP 98-1 applies to the individual modules or components of the computer system. For each component or module of a software project, amortization should begin when the component or module is ready for its intended use, regardless of whether the software will be placed in service in planned stages that may extend beyond the reporting period. Auditors should ensure that contractors separately account for costs by module or component to comply with this requirement. Computer software is ready for its intended use after all substantial testing is complete. If the functionality of a module is entirely dependent on the completion of other modules, amortization of that module should begin when both that module and the other modules upon which it is functionally dependent are ready for their intended use.

7-106 Accounting for Costs of Computer Software to be Sold, Leased or Otherwise Marketed (FASB No. 86)

a. FASB Statement No. 86 "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed," specifies the financial accounting treatment for the costs of computer software sold, leased, or otherwise marketed either as a separate product or as a part of another product or process. FASB No. 86 identifies the point in time that research and development costs incurred in the process of creating a software product to be sold, leased, or otherwise marketed become production costs which should be capitalized and amortized over future sales.

b. FASB 86 provides that costs incurred internally in creating a computer software product are to be charged to expense when they are incurred as research and development until "technological feasibility" has been established for the product. Technological feasibility is established when either (1) the detailed program design has been completed or (2) a working model has been developed. After technological feasibility has been established, all software production costs are to be capitalized and reported on the financial statements at the lower of unamortized cost or net realizable value and are to be amortized based on current and future revenue. Capitalization of software costs shall stop when the product is available for general release to customers.

7-200 Section 2 --- Lease Cost

7-201 Introduction

This section provides guidance for evaluating leasing costs.

7-202 Applicable Contract Regulations

7-202.1 Applicability of FASB Statement 13

Guidance for the treatment of lease costs is covered by Financial Accounting Standards Board (FASB) Statement No. 13, Accounting for Leases. The Statement is effective for leasing transactions and revisions entered into on or after January 1, 1977. For leases in effect on January 1, 1977, FASB Statement 13 was optional until fiscal years beginning on or after December 31, 1980. FASB Statement 13 is incorporated in FAR 31.205-36 (Rental Costs), and FAR 31.205-11 (Depreciation).

7-202.2 Applicability of FAR

FAR 31.205-36 applies to the cost of renting or leasing real and personal property, acquired under operating leases (see 7-205) as defined in FASB Statement No. 13. If the lease is classified as a capital lease, the provisions of FAR 31.205-11 (Depreciation) apply (see 7-413).

7-202.3 Applicability of CAS

CAS 404, Capitalization of Tangible Assets, is incorporated in FAR 31.205-11(m). CAS 404 applies to assets acquired by a capital lease as defined by FASB Statement 13. Compliance with FASB Statement 13 and CAS 404 requires that capital leases be treated as purchased assets. The capitalized value of such assets should be distributed over the useful lives of the leased assets as depreciation charges, or over the leased life as amortization charges, as appropriate.

7-203 Capital Leases

If the lease is classified as a capital lease, the provisions of FAR 31.205-11 (Depreciation) and CAS 404 apply (see 7-413 and 7-202).

7-203.1 Main Requirements of FASB Statement 13

a. **Criteria for Classification as a Capital Lease.** From the standpoint of the lessee, the lease shall be classified as a capital lease if any of the following criteria are met:

(1) The lease transfers ownership of the property to the lessee by the end of the lease term.

(2) The lease contains a bargain purchase option.

(3) The lease term is equal to 75 percent or more of the estimated economic life of the leased property. However, where the lease term begins in the last 25 percent of estimated economic life, this criterion shall not be used to classify the lease.

(4) The present value, at the beginning of the lease term, of the minimum lease payments (excluding executory costs such as insurance, taxes, etc.) equals or exceeds 90 percent of the excess of the fair value of the leased property over any related investment tax credit retained by the lessor. The 90 percent test should be considered a lower limit rather than a guideline. However, where the lease term begins in the last 25 percent of the estimated economic life, this criterion shall not be used to classify the lease.

b. **Determination and Amortization of Minimum Lease Payments.** (1) Capital leases should be recorded as assets and liabilities at the lower of the present value of the minimum lease payments at the beginning of the lease term or the fair value of the leased property at the inception date. The discount rate used in determining present value is the lower of the lessee's incremental borrowing rate (the rate the lessee would have incurred to borrow the funds necessary to purchase the asset) or the implicit (lessor's) rate in the lease, if the implicit rate can be determined. The minimum lease payments are allocated between a reduction of the liability and interest ex-

pense to produce a constant periodic interest rate on the remaining balance.

(2) A leasee may use its secured borrowing rate in calculating the present value of minimum lease payments if the rate is determinable, reasonable, and consistent with the financing that would have been used in the particular circumstances.

(3) Contingent rentals are the increases or decreases in lease payments that result from changes occurring subsequent to the inception of the lease in the factors (other than the passage of time) on which lease payments are based. Lease payments that depend on a factor directly related to the future use of the leased property, such as machine hours of use or sales volume during the lease term, are contingent rentals and, accordingly, are excluded from minimum lease payments in their entirety. See 7-204.2 regarding lease payments dependent on economic escalation factors.

c. **Calculation of Amortization (Depreciation) for a Capital Asset.** The asset shall be amortized in a manner consistent with the lessee's normal depreciation policy for owned assets. See 7-400 for a discussion of depreciation costs. The asset shall be amortized over a useful life as follows:

(1) If the leased property reverts to the lessee at the end of the lease or if the lessee is able to purchase the property at a bargain purchase price, then the asset life will be that normally used by the contractor for similar assets.

(2) If the property is leased for a term which is 75 percent or more of the economic life of the asset or the minimum lease payments equal or exceed 90 percent of the fair value of the asset (less applicable credits) then the asset should be amortized over the life of the lease to the value to the lessee, if any, at the end of the lease.

d. **Renewals and Terminations.** (1) If a capital lease is renewed or extended and the renewal is also classified as a capital lease, the carrying value of the asset may require adjustment. When the capitalized value under the revised lease and the present balance of the obligation differ, the asset and liability account is adjusted upward or downward to reflect this difference.

(2) If a capital lease is renewed or extended and the renewal is classified as an operating lease, the existing lease shall continue to be accounted for as a capital lease to the end of the original term, and the renewal or extension period shall be accounted for as an operating lease.

(3) A termination of a capital lease shall be accounted for by removing the asset and obligation with gain or loss recognized for the difference.

(4) The exercise of a lease renewal option contained in a current lease other than those already included in the lease term (as defined by FASB Statement 13) is classified as a new agreement and not a renewal or extension.

7-203.2 Audit Considerations---Capital Lease

a. **Proper Classification of Leases.** (1) Auditors should use the computer program which has been developed to assist in determining whether a lease should be classified as an operating lease or a capital lease. The FASB13.ZIP program, for example, is available on the DCAA Intranet, under File Libraries, to assist the auditor in determining if a lease has met the "90 percent" criterion for classification as a capital lease (see 7-203.1a(4)).

(2) Auditors should be alert to instances where, to avoid reporting liabilities on their financial statements, contractors may structure their leases, or include assumptions in testing against the FASB Statement 13 criteria, that result in those leases being classified as operating.

(3) When a capital lease is improperly classified as an operating lease, the excess leasing costs should be determined based on criteria for computing the unallowable leasing costs for capital leases. The cost of leased capital assets in excess of the prescribed depreciation charges (7-202.3) should be disapproved under FAR 31.205-11(m). FAR 31.205-20 (Interest and Other Financial Costs) should not be cited as a basis for disapproving the costs.

(4) Mitigating circumstances involving materiality determinations may exist. For

example, leases reclassified as capital leases may result in depreciation during the early years of the leases at amounts higher than the lease payments due to use of accelerated depreciation methods and applied cost of money (COM). The total depreciation and COM under a capital lease may be greater than the total leasing costs. The practice may be in noncompliance with FAR 31.205-11 or FAR 31.205-36 or CAS 404, 405, 409, or 414. These regulations and standards should be reviewed for applicability. The noncompliance should be reported if it currently has no significant effect on contract costs but could eventually result in a significant adjustment because of changed circumstances.

b. **Unreasonable Lease Costs.** If the lease term is substantially shorter than the asset's useful life, the recovery of a high percentage of the fair market value of the asset over the lease term would be indicative of unreasonable rental costs. In this situation, the auditor should determine if the lessor considered and provided adequate residual value at the end of the lease term in accordance with paragraph 5(k) of FASB Statement 13. Reasonable residual value must be considered in computing minimum lease payments in order to attain reasonable lease costs.

c. **Amortization Period.** The proper classification of a lease according to FASB Statement 13 does not automatically result in acceptable contract cost. For capital leases, consideration should be given to the acceptability of the amortization period in accordance with FASB Statement 13 and CAS 409.

(1) Definition of Lease Term

FASB Statement 13 defines a lease term as the fixed noncancellable term of the lease plus (i) all periods covered by bargain renewal options, (ii) all periods for which failure to renew the lease imposes a penalty on the lessee in an amount such that renewal appears, at the inception of the lease, to be reasonably assured, (iii) all periods covered by ordinary renewal options during which a guarantee by the lessee of the lessor's debt related to the leased property is expected to be in effect, (iv) all periods covered by ordinary renewal options preceding the date as of which a bargain purchase option is exercisable, and (v) all periods representing renewals or extensions of the lease at the lessor's option. However, in no case shall the lease term extend beyond the date a bargain purchase option becomes exercisable.

(2) Audit Considerations

When a capital lease is to be amortized over the lease term (see 7-203.1c), renewal periods will be included if they meet the criteria specified in the FASB Statement 13 definition of a lease term. This would be an important audit consideration when the renewal is assured through substantial penalties for nonrenewal or a guarantee by the lessee of the lessor's debt. Failure to review the lease term for renewal clauses could significantly distort the amortization charges to current contracts.

7-204 Review of Lease Clauses

7-204.1 Payment of Executory (Occupancy) Cost

Lease clauses regarding payment of executory costs are of particular interest to the auditor. FASB Statement 13 requires executory costs to be excluded when computing minimum lease payments. Executory costs include maintenance, insurance, taxes, and utilities. When the lease clause provides that the lessee pays the executory costs, the lease is referred to as a "net" lease. When the lessor pays these costs, the lease is referred to as a "gross" lease. Since "net" and "gross" are not universally defined, the auditor should review the lease clause to determine exactly what costs are to be paid by the lessee.

7-204.2 Escalation Lease Clauses

Auditors should be particularly interested in escalation lease clauses. Recently, clauses containing a provision for increasing lease payments based on the Consumer Price Index (CPI) or some other economic indicator have become common. The increase could be subject to adjustment on an annual basis or when an option is exercised. The escalation may also apply to the purchase price if the lease contains a purchase option.

a. **Computation of Minimum Lease Payments.** The decision to include or exclude the escalation for purposes of computing minimum lease payments depends on the specific circumstances, and would include:

(1) the factor(s) to which the escalation applies, such as executory costs (which would not be included at all), principal payments, or insurance only;

(2) the factor on which the escalation is computed, such as the CPI or prime interest rate,

(3) the period to which the escalation applies, such as annually, only for an option period, or the incurrence of some period of time, and

(4) the current pronouncements of the Financial Accounting Standards Board.

b. **CPI or Prime Interest Rate.** Lease payments that depend on an existing index or rate, such as the CPI or prime interest rate, shall be included in minimum lease payments based on the index or rate existing at the inception of the lease. Any increases or decreases in lease payments that result from subsequent changes in the index or rate are contingent rentals and are excluded from the minimum lease payments (see 7-203.1b(2)).

7-205 Operating Leases

7-205.1 Definition of Operating Lease

Under the provisions of FASB Statement 13, an operating lease is any lease that is not a capital lease.

7-205.2 Criteria for Allowability

The provisions of FAR 31.205-36 apply to all operating leases including those that involve information technology equipment. The main criterion for allowability of operating lease costs is reasonableness. The cost principle states several criteria that should be considered when making a determination of reasonableness. The provisions in FAR 31.201-3 should also be used in evaluating reasonableness of operating lease cost.

7-205.3 Audit Procedures

a. **Comparison with Comparable Property – FAR 31.205-36(b)(1)**. Included in these criteria is a comparison with comparable property. The auditor must exercise care when determining what is comparable property. To be comparable, the property must be of the same basic age, size, life expectancy, and location. In addition, the lease provisions must also be comparable. Since there are several clauses which can increase time lease costs (see 7-204), the auditor must ascertain what costs truly are included in the comparable property comparison.

b. **Determination of Reasonableness – FAR 31.205-36(b)(1) and 31.201-3**. (1) An audit step in testing reasonableness is to review the results of applying FASB Statement 13 capitalization criteria. This is especially critical when reviewing the results of the application of the fourth criteria of FASB Statement 13 (7-203.1a(4)). Auditors should determine whether the lease term is substantially less than the asset life, and whether the present value of the minimum lease payments is significant as compared to the fair market value of the leased property (for example, greater than 50 percent but less than 90 percent). If this condition exists, there is a strong indication that lease costs are unreasonably high and the audit scope should be expanded.

(2) Auditors should be alert to computer programs available from DCAA, the contractor, or other sources to assist them in determining reasonableness. One such program is DCAA's LVPA program, which can be located on DCAA’s Intranet under File Libraries, DCAA Software Applications. The program computes and compares cumulative leasing costs with cumulative constructive ownership costs, and can be adjusted for most any lease vs. ownership analysis.

7-206 Related Party Lease Cost

Leases between related parties are governed by FASB Statement 13, FAR 31.205-11(m)(2), Depreciation, and FAR 31.205-36(b)(3), Rental costs.

7-206.1 Related Party Capital Leases

a. **FASB Statement 13 and FAR Requirements**. Capital leases between related parties are discussed in FAR 31.205-11(m)(2) and FASB Statement 13 (FAS-13), paragraph 5a. If it is determined that the terms of the lease have been significantly affected by the fact that the lessee and lessor are related, costs shall not be allowed in excess of those which would have been incurred if the lease contained terms consistent with those found in a lease between unrelated parties.

b. **Audit Procedures**. The auditor should test for reasonableness of rental costs by comparing the present value of lease payments with the fair market value prior to applying the provisions of FASB Statement 13. If the present value substantially exceeds the fair market value, the economic substance of the transaction should be recognized over the "legal form" (see FAR 31.205-11(m)(2) and FASB Statement 13, paragraph 29). Consequently, costs should be questioned to the extent of unreasonableness due to lack of an "arms length bargaining" (FAR 31.201-3(b)). FASB Statement 13 criteria should then be applied in establishing the appropriate treatment for the balance of the costs.

7-206.2 Related Party Operating Lease

a. **General**. Leasing costs between divisions, subsidiaries, or organizations under common control for operating leases are generally allowable to the extent that costs do not exceed the normal costs of ownership (excluding interest or other costs unallowable and including cost of money) (FAR 31.205-36(b)(3)). To help analyze the lease versus ownership costs, auditors should use DCAA's LVPA program. The program computes and compares cumulative leasing costs with cumulative constructive ownership costs, and can be adjusted for most any lease vs. ownership analysis. It is available on DCAA’s Intranet under File Libraries, DCAA Software Applications.

b. **Common Control**. FAR does not specifically define common control. ASBCA decisions on common control have emphasized the existence or lack of existence of actual common control. FAS 57 defines control as "The possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract, or otherwise." The question of whether two entities are under common control is a question of fact. The key question is whether or not one party has the ability to exercise control over the operating and financial policies of the related party. A party may have actual control even if such control is not evidenced by the agreement. Therefore, it is imperative to review the events and transactions that actually occurred in making a determination of whether or not control exists. Two of the most important areas to review are (1) the actual decision making process, and (2) the reasonableness of the lease terms.

(1) A review of the joint venture decision making process is important to determine if control actually exists. For example, if it appears that one company is making practically all the decisions (e.g. the other party is not present at decision making meetings, or if present rarely provides input), this would be an indication that this company is controlling the joint venture. In reviewing supporting documentation, the auditor should remember that percentage of ownership is only one factor to be considered. It is possible that common control will exist even where the controlling individuals own a small percentage of the company's equity. Other factors to consider include, but are not limited to, interlocking management/ownership, identity of interests among family members, shared facilities and equipment, and common use of employees.

(2) The existence of unreasonable lease terms may also provide evidence of control. If the lease terms are unreasonable as compared to those available in the competitive market, it may be because one company has exercised significant influence over the operating and financial policies of the joint venture. Reasonableness may be reviewed by comparing the terms of the lease with (a) the contractor's other comparable leases that did not involve a related party, (b) other comparable leases, and (c) actual advertised prices for the facilities in question or other

similar facilities. Both the rates (cost per square foot for example) and other terms (such as fixed noncancellable leases versus those with options) must be considered in determining the reasonableness of the lease costs.

While showing that the lease costs are unreasonable will not in itself constitute a determination of common control, it is an important factor in making such a determination. In addition, if the government is unable to prevail in its common control argument, it nevertheless should prevail in proving that the lease costs were unreasonable at the time of the lease decision under the provisions of FAR 31.205-36(b)(1).

7-207 Sale and Leaseback Transactions

a. Leasing costs under a sale and leaseback arrangement are allowable only up to the amount that would be allowed had the contractor retained title. Sale and leaseback transactions are governed by FASB Statement 13, FAR 31.205-11(m)(1), Depreciation, and FAR 31.205-36(b)(2), Rental costs.

b. A gain from the sale of a depreciable asset that is simultaneously leased back under the type of arrangement covered by FAR 31.205-36(b)(2) should not be recognized as a credit to overhead in the year in which the arrangement was transacted. The allowable lease costs under such an arrangement are limited to the depreciation expense that would have been charged for the same period as if the sale/leaseback arrangement had never been transacted. If at the time of actual disposition of the leased asset, there continues to be a gain or loss associated with the asset, this gain or loss should be recognized.

7-300 Section 3 --- Allocation of Special Facilities Operating Costs

7-301 Introduction

a. This paragraph provides guidance on the treatment of the operating costs of certain facilities, which, if not properly accounted for, could fail significantly to measure the benefits accruing to the several cost objectives.

b. The guidance includes (1) definition of applicable facilities, (2) criteria for determining whether the contractor is using an acceptable basis for charging or distributing costs to work benefited, and (3) criteria for determining billing or costing rates. Allocation of computer operating costs is covered in 7-100.

c. In the course of implementing the following guidelines, including the development of any recommendation to change an established and previously acceptable accounting procedure with respect to a particular facility, the principles below are not to be applied so rigidly as to complicate unduly the allocation where substantially the same results are achieved through less precise methods.

7-302 Criteria for "Special Facilities"

Facilities to which this guidance is applicable cannot be specifically designated by name or type but rather must be determined by whether or not they meet certain basic criteria. The first criterion to be met is that the costs involved in the operation of each facility must be significant in amount with respect to the contractor's overall operations. The second criterion is that the facility benefits only a limited portion of the contractor's total workload. Wind tunnels and space chambers are representative of facilities which, if they meet the criteria above, would be subject to the guidance provided in this section.

7-303 Methods for Allocating Costs to Benefiting Work

There are three basic methods for allocating costs related to facilities which meet the criteria in 7-302, although variations may be encountered. If a variation appears to reasonably measure the benefits accruing to the several cost objectives, its use should be satisfactory. The three basic methods are described below.

7-303.1 Method 1 --- Full Costing on Usage Basis

Under the first method, all readily identifiable direct costs are charged to projects, contracts, or other work involved. Additionally, all general operating costs of the facility, such as rentals, depreciation (including obsolescence), amortization, repairs, maintenance, supplies, and general support salaries and wages, are allocated to the using projects, contracts, or other work involved, on a usage or other quantitative basis. Generally, this method yields the most equitable results and should be used if cost and usage data for the facility can be economically accumulated with reasonable accuracy. If it is determined that use of methods 2 or 3 below would yield inequitable cost allocations, cost data which will permit the determination of costs by method 1 should be maintained by the contractor.

7-303.2 Method 2 --- Only Directly Identifiable Costs Allocated on Usage Basis

Under the second method, readily identifiable direct costs are charged to the projects, contracts, or other work involved, as in method 1 above. However, all general operating costs of the facility, such as rentals, depreciation (including obsolescence), amortization, repairs, maintenance, supplies, and general support salaries and wages are included in the distribution through one of the contractor's appropriate categories of indirect expense. Although this method is less precise than method 1, its use is satisfactory if it reasonably measures the benefits accruing to the several cost objectives.

7-303.3 Method 3 --- General Indirect Cost Allocation

Under the third method, all costs associated with the facility, including direct labor and material, are grouped and dis-

tributed through one of the contractor's appropriate categories of indirect expense. This method should be used only when the contractor demonstrates that (1) neither method 1 nor 2 above is practical and (2) its use is unlikely to result in any significant failure to measure the benefits accruing to the several cost objectives.

7-304 Treatment of Microelectronic Center (MEC) Costs

a. On January 8, 1990, the Acting Under Secretary of Defense for Acquisition (USD(A)) issued guidance concerning the treatment of MEC costs. This USD(A) guidance provides that "The costs of developing and deploying new or improved systems, processes, methods, equipment, tools and techniques to produce the next-generation microelectronics needed for future weapons systems are allowable in accordance with Federal Acquisition Regulation (FAR) 31.205-25, and should be allocated over an appropriate business base in accordance with FAR 31.201-4(c), until such time as the MEC is being substantially utilized for actual production efforts."

b. The Office of Defense Procurement (ODP) generally classifies MECs as special facilities, and therefore CAS 418 is not applicable to MECs. The MEC facility at a specific contractor may not qualify as a "special facility." For example, if the activities performed by the MEC facility are functionally identical to current engineering and manufacturing activities, the facility may not be "special" in nature. CAS 418 noncompliance reports must include an explanation as to why the particular MEC in question does not qualify as a "special facility."

c. Usually, the number of actual units produced by an MEC facility during the development phase will be small, but will increase gradually as the contractor approaches normal production levels. As a result, if the costs of facilities or equipment incurred at the smaller production level are allocated in total to the units produced, an inordinate amount of costs would be allocated to these units during the development period. Development efforts, when completed, will provide a broader applicability than the utilization in current production represents. Thus, the portion of these costs that represent development efforts should be allocated over a broader business base until the MEC facility approaches anticipated normal and/or substantial production levels, i.e., until the facility achieves self-sufficiency. Any such allocation of development costs should be done on an objective basis.

d. One of the key factors to consider in reviewing MEC costs is the basis used for distinguishing the production efforts from the development efforts. Whatever basis is used, it should be objective in nature to assure that allocations are based upon benefits received and that a broad business base allocation is applied to the development costs only until such time as the facility becomes self-sufficient. For example, an objective basis could include an allocation of total MEC costs based upon the proportion of production effort to development effort. In other circumstances, it may be possible to identify the specific functions associated with production and those associated with development, with an allocation of costs made accordingly.

7-305 Determination of Costing Rates for Special Facilities

7-305.1 Basic Procedures for Costing Rates

a. General operating costs of those facilities which meet the criteria in 7-302 and for which method 1 above is considered appropriate should generally be charged to users by means of actual or predetermined billing or costing rates as provided below. This will require maintenance of a time log for each facility to record the hours of time spent by each user. The period covered by the billing or costing rates will not normally exceed 12 months. See 8-406 for CAS-covered contractors and FAR 31.203(e) for non-CAS-covered contractors.

b. When only one rate for the facility is to be applied, it should consist of the actual or estimated applicable costs divided by the actual or estimated number of hours or other units composing the basis.

7-305.2 Treatment of Real and Estimated Cost Differentials

a. When real cost differentials (such as certain services furnished during prime shifts only or by different facilities) exist and can be readily demonstrated, separate rates for such cost differentials may be used.

b. In the case of educational institutions, when rental or lease costs are based upon prime-shift usage, second and third shift usage may, with appropriate approval, be charged at reduced rates.

c. Under certain situations, reasonably estimated differential costs may be used in instances where cost differentials logically exist but cannot be determined precisely by contractor. For example, such differentials would permit priority, interrupt, or short-turnaround time runs at premium rates and/or nonpriority, non-prime-time, or large-volume runs at reduced rates.

d. Whether a single rate or several rates are used, the rates should be so designed as to recover, or closely approximate total recovery of, costs from all users of the facility. Where differing rates are used, they should be applied to all users on a nondiscriminatory basis. The costing of accommodations sales at reduced rates is not considered appropriate.

7-305.3 Treatment of Under- or Overabsorbed Rates

Any immaterial under- or overabsorption of costs resulting from application of predetermined rates may be charged or credited to an appropriate category of indirect expense. If the under- or overabsorption is material, it should be treated in accordance with the CAS-covered contractor's disclosed practices (see 8-418).

7-306 Treatment of Manufacturer Discounts to Educational Institutions

When the manufacturer leases or sells the equipment below commercial prices to an educational institution as an allowance to education, the allowance should be treated as a reduction of the cost of leasing or purchasing.

7-307 Treatment of Grants for Special Facilities

When the contractor (usually a university) has received a grant from the government to be used in connection with a particular facility, application of the funds provided should be in accordance with the terms of the grant.

7-400 Section 4 --- Depreciation Costs

7-401 Introduction

This section contains guidance on depreciation costs under research and supply contracts with commercial organizations. The guidance in this section covers only the FAR provisions regarding depreciation costs.

7-402 Contract Provisions on Depreciation

7-402.1 General Applicability of FAR and CAS

a. The provisions of FAR 31.205-11 govern the allowability of depreciation costs. Contractors with contracts subject to cost accounting standards (CAS) must comply with the provisions of CAS 409, Depreciation of Tangible Capital Assets, and CAS 404, Capitalization of Tangible Assets. CAS 404 and CAS 409 are incorporated into FAR Part 31.

(1) CAS-covered contractors may elect to comply with CAS 409 on their contract(s) not subject to CAS 409. Contractors electing to comply with CAS 409 on their non-CAS covered contracts must comply with all provisions of the standard.

(2) In some cases the provisions of FAR 31.205-11 may conflict with the provisions of CAS 409. When CAS 409 is applicable, its provisions supersede any conflicting provisions of FAR 31.205-11.

b. Guidance on the cost accounting standards is in Chapter 8 and will not be repeated here. Auditors should refer to Chapter 8 for guidance on auditing depreciation costs on CAS covered contracts.

c. Guidance in the application of the FAR provisions is presented below.

7-402.2 General Allowability Criteria of FAR

Normal depreciation is generally considered allowable contract costs if reasonable and allocable.

a. Depreciation Same For Both Financial and Income Tax Purposes

(1) For non CAS covered contracts under FAR 31.205-11(d), costs are reasonable if the contractor follows policies and procedures that are (1) consistent with those followed in the same cost center for business other than government, (2) reflected in the contractor's books of accounts and financial statements, and (3) both used and accepted for Federal income tax purposes.

(2) However, due to unusual circumstances affecting defense contracts, the contractor's policies and procedures may result in inequitable charges to the government. If any inequities are found, Headquarters should be advised.

b. Depreciation For Financial Purposes Differs From Income Tax Purposes

(1) If a contractor subject to FAR 31.205-11 rather than CAS 409 does not use the same policies and procedures for financial/book purposes and Federal income tax purposes, reimbursement shall be based on the asset cost amortized over the estimated useful life of the property using depreciation methods (straight line, sum of the years-digits, etc.) acceptable for income tax purposes. Allowable depreciation shall not exceed the amounts used for book and statement purposes and shall be determined in a manner consistent with the depreciation policies and procedures followed in the same cost center on non-government business (FAR 31.205-11(e)).

(2) However, if the amounts used for book and statement purposes are not reasonable or equitable for contract cost purposes, costs should be questioned.

7-402.3 Relationship Between FAR and IRS Regulations on Depreciation

a. Tax Methods versus Financial Statement Methods of Depreciation

(1) In 1986 changes were made in the Internal Revenue Code and implementing regulations to permit the use of accelerated methods of depreciation in determining taxable income. Since that time many companies have adopted these methods for income tax purposes in order to defer payment of taxes and to improve cash

flow, while for book and financial statement purposes they continue to use the traditional straight-line method of depreciation. Thus, the amount of depreciation charged to operations under the contractor's established depreciation policies and procedures may often differ from the amount claimed for Federal income tax purposes.

(2) The FAR cost principles applicable to non CAS covered contracts recognize this situation by providing that, where the contractor uses the same method for book and tax purposes, the auditor will be guided by the provisions of FAR 31.205-11(d), which incorporate by reference certain criteria in the Internal Revenue Code. On the other hand, where the book and tax methods differ, the amount allowable for the fiscal period for contract cost purposes is determined on the basis outlined in FAR 31.205-11(e) and may not exceed the book/statement amount.

b. Contract Audit Responsibility Related to IRS Reviews of Depreciation

(1) The Internal Revenue Service regulations which implement Section 167 of the Internal Revenue Code of 1954, as amended, prescribe detailed criteria for determining depreciation costs. These criteria are intended to be understood and applied not only by IRS personnel but also by businessmen as well as professional accountants and auditors so as to obtain substantially the same results. FAR 31.205-11(d)(3) should therefore not be construed-nor was it intended-to require defense procurement or audit personnel to wait for IRS post audit approval (or disapproval) of an income tax return before the amount of allowable depreciation costs is determined for contract cost purposes.

(2) DCAA auditors should therefore acquire and maintain a working knowledge of the IRS code and regulations on depreciation. It should also be noted in this regard that the taxpayer (contractor) can enter into a written agreement with the IRS in advance of filing its tax return to determine the tax liability on any unusual situation which it does not consider sufficiently covered in the IRS regulations. The auditor should be aware of any such agreement.

7-403 General Audit Techniques for Depreciation Costs

7-403.1 Review of Contractor Depreciation Records

A proper determination of periodic depreciation costs depends largely on the effectiveness and consistency of the contractor's depreciation policies and procedures and on the sufficiency of the related property/depreciation records. Because an interrelationship exists between the amount of depreciation cost chargeable to any fiscal period as compared with prior and/or future fiscal periods, completeness of such records for the entire retention period of the asset(s) is essential. In auditing these records, the following considerations warrant special attention.

7-403.2 Review of Contractor Depreciation Policies and Procedures

The auditor should review the contractor's depreciation policies and procedures and perform selective tests to determine whether the policies and procedures have been followed to calculate depreciation for the accounting period being audited.

7-403.3 Review of Asset Cost

The auditor should determine if the capitalized asset cost, including any cost of making the asset ready for use, is supported by the contractor's accounting records. This may include verifying the cost of the asset to supporting documents such as purchase order, vendor invoice, and cancelled checks. It may also include reviewing the cost of betterments, as well as determining if asset retirements have been properly accounted for.

7-403.4 Review of Contractor's Schedule M and IRS Audit Reports

The examination should also include a review of Schedule M of the contractor's Federal income tax return and the results of any review of the tax returns made by the Internal Revenue Service. In the event the IRS has made any changes, the auditor should evaluate the amounts and circum-

stances and make whatever adjustments are appropriate to determine allowable depreciation costs of the current or prior years. The review of Schedule M will indicate whether the contractor's method of computing depreciation for tax purposes differs from that used for book and statement purposes. This is important since the criteria in FAR 31.205-11(e) which applies to contracts that are not covered by CFR 9904.409, states that if the amounts differ, allowable depreciation shall not exceed the amounts used for accounting books and financial statement purposes.

7-403.5 Review of Contractor Financial Statements

The contractor's financial statements should reflect the amount of depreciation charged to operations on the contractor's books. Financial statements are considered to be those statements which are annually certified and distributed to stockholders and others. Since such statements generally cover company-wide operations, the FAO responsible for the audit of the home office should serve as the focal point for assistance to other field audit cognizance.

7-404 Special Considerations--- Depreciation Cost Charged to Government Contracts

The fact that the contractor's overall book and statement depreciation is also used for Federal income tax purposes, and is acceptable for such purposes, does not necessarily mean that the depreciation charged to defense contracts is acceptable.

7-404.1 Allocation of Depreciation

Depreciation should usually be allocated to the contract or other work as an indirect cost.

a. Identification to Organizational Units

Depreciation should preferably be determined and recorded for each department, cost center, or similar organizational segment, so that the cost is identified as closely as possible with the benefiting work or activity. Where plant or company-wide rates are being used, the auditor should make sufficient tests to determine that the end results are substantially the same as would be achieved by relating depreciation to government contracts by more refined methods.

b. Inequities of Company or Plant-wide Basis

Allocation of depreciation on a plant-wide basis may not be equitable, for example, where the government work is being performed in only part of the facilities, or where the contractor is replacing assets in the plant areas performing primarily commercial work more rapidly than in the segments engaged in defense work.

c. Reporting Requirements

Where the auditor determines that the contractor's use of plant or company-wide rates does not currently result in an inquitable cost allocation, the auditor may consider it necessary to formally notify the contractor that if the cost pattern or nature of the work changes so as to result in inequitable charges against government contracts, the method will no longer be acceptable.

7-404.2 Depreciation Methods for Commercial Versus Government Work

In any given cost center, various classes of assets may be depreciated under more than one method. If so, the auditor should ascertain that the depreciation methods do not vary between assets used for commercial products and those used for government work so as to result in discrimination against government contracts.

7-404.3 Depreciation on Assets Acquired from the Government and Depreciation of Fully Depreciated Assets

a. Determine whether the contractor has claimed depreciation on those types of property described in FAR paragraphs 31.205-11(j) and (l). These paragraphs relate principally to assets acquired from the government at no cost to the contractor and fully depreciated assets.

b. Usage charges for fully depreciated assets are permitted under certain circumstances. FAR 31.205-11(l) states that "... a reasonable charge for using fully depreciated property may be agreed upon and al-

lowed." A usage charge may be appropriate when the actual useful life of an asset exceeds its estimated useful life and there has been a significant change in government participation after the asset was fully depreciated. In such cases, the allocation of the cost of the asset usage between government and commercial contracts may be adjusted by applying a usage charge.

c. In reviewing contractor claims for usage charges, it is imperative that the auditor determine if the actual useful life of the asset exceeds the estimated useful life due to a betterment, an error in estimate, or a patchwork repair.

(1) Betterment. CAS 404-40(d) states that "Costs incurred subsequent to the acquisition of a tangible capital asset which result in extending the life or increasing the productivity of that asset (e.g. betterments and improvements) and which meet the contractor's established criteria for capitalization shall be capitalized..." Accordingly, in those cases where the useful life of the asset extends beyond its estimated life as a result of a betterment, CAS requires that the contractor adjust the estimated life of the asset. If the contractor has failed to make such an adjustment, then the asset is not fully depreciated and the usage charge should be disallowed.

(2) Error in Estimate. On a few occasions, the contractor may have an asset that lasts longer than its estimated useful life as a result of an error in the contractor's original estimate. In these cases, the contractor may be entitled to a usage charge (see 7-404.3(d)). However, when the actual useful lives of the contractor's assets exceed the estimated useful lives on a recurring basis, the auditor should review the contractor's estimating procedures to assure that they comply with the requirements of CAS 409. If the assets are fully depreciated as a result of a noncompliance with CAS 409, the usage charge should be disallowed.

(3) Patchwork Repair. On rare occasions, a contractor may decide to continue to utilize an asset beyond its useful life through continual patchwork repairs. In these cases, the contractor may be entitled to a usage charge (see 7-404.3(d)). However, the auditor should review the contractor's rationale for continually repairing the asset rather than overhauling the asset (a betterment), trading in the asset, or scrapping the asset in favor of a new one. The auditor should consider factors such as the cost of patchwork repairs, the utilization of contractor personnel in performing these repairs, the cost of an overhaul, the trade-in value of the old asset, and the cost of a new asset.

d. Approval and Computation of Usage Charge.

(1) When the continued use of a fully depreciated asset is appropriate under the circumstances, FAR 31.205-11(l) provides that the allowability of a usage charge is subject to the approval of the contracting officer. While usage charges are permitted under the FAR, there is no requirement that the contracting officer allow the charges.

(2) When a usage charge is allowed, the amount of the charge should be determined on a case-by-case basis. In determining a reasonable usage charge, the auditor should make sure that the contractor has properly considered each of the factors listed in FAR 31.205-11(l), including the cost, estimated useful life at the time of negotiations, effect of any increased maintenance charges or decreased efficiency due to age, and the amount of depreciation previously charged to government contracts or subcontracts. To demonstrate how a reasonable usage charge may be calculated, an example is shown below:

Cost of asset		$100,000
Original Estimated Useful Life		3 years
Actual Useful Life		5 years
Total estimated decrease in efficiency for Years 4 and 5 ($2,000 per year)		$4000
Total estimated increase in maintenance (patchwork repairs) for Years 4 and 5 ($2,500 per year)		$5,000
Average Government Participation for Years 1 through 3		50%
Average Government Participation for Years 4 and 5		90%
Calculation of Recommended Usage Charge:		
Depreciation expense charged to the government if the estimated useful life had been 5 years:		
Years 1 thru 3 ($20,000 per year X 3 years X 50%)		$30,000
Years 4 and 5 ($20,000 per year X 2 years X 90%)		$36,000
	(a)	$66,000
Less: Actual Depreciation Expense charged to government contracts ($100,000 X 50%)	(b)	$50,000
Additional depreciation due to extended useful life	(c) = (a) - (b)	$16,000
Less: Efficiency Reduction ($4,000 X 90%)	(d)	$3,600
Increased Maintenance ($5,000 X 90%)	(e)	$4,500
Allowable Usage Charge	(c) - [(d) + (e)]	$7,900

7-404.4 Depreciation on Intracompany Transfers of Assets

On property acquired from a division, subsidiary, or affiliate of the contractor, the auditor's attention is directed to FAR 31.205-11(k) which provides that the depreciation on any such item which meets the criteria for allowance at a "price" under FAR 31.205-26(e) may be based on such price (rather than cost to the contractor), provided the same depreciation policies and procedures are used for costing purposes for all business of the using division, subsidiary, or organization under common control.

7-404.5 Depreciation on Idle Facilities or Idle Capacity

The auditor should ascertain whether any of the depreciation costs charged to government contracts are generated by idle facilities or idle capacity as these terms are defined in FAR 31.205-17. If this is determined to be the case, the applicable depreciation cost should be treated as part of the total idle facility or idle capacity cost.

7-404.6 Depreciation Under Novation Agreements

For contracts being performed under novation agreements, depreciation allowed to the successor contractor should not exceed the amount which would have been allowed to the predecessor contractor to which the contract was originally awarded (see 7-1700).

7-405 Estimated Useful Life for Depreciation

7-405.1 The Economic Usefulness Criterion of FAR 31.205-11(e)

Where depreciation reflected on the contractor's books/statements differs from that used and acceptable for income tax purposes, the estimated useful life of an asset should represent the prospective period of economic usefulness to the contractor as defined in FAR 31.205-11(a). When either useful life, residual value, or depreciation methods differ for book and tax purposes, then the provisions of FAR 31.205-11(e) should be applied in determining allowable depreciation costs (7-402.2(b)). Under this FAR provision allowable depreciation shall not exceed the amounts used for book and statement purposes. If the auditor concludes, with technical assistance, if necessary, that depreciable lives used by the contractor for book purposes do not represent "economic usefulness", depreciation costs should be questioned.

7-405.2 Useful Lives Under FAR 31.205-11(d)---ADR Guidelines

Where allowable depreciation costs are to be determined under FAR 31.205-11(d) (see 7-402.2(a)), useful lives should be assigned as provided in asset depreciation range (ADR) guidelines, where applicable. These guidelines are summarized and discussed below.

a. Bulletin F-Before 1962

Before 1962, business firms depreciated property in terms of useful lives established for several thousand different classifications of assets by Treasury Department Bulletin F. Taxpayers may still use Bulletin F as a guide if they wish, but generally do not do so since subsequent regulations provide for shorter lives.

b. Revenue Procedure 62-21 - July 1962

In July 1962, Revenue Procedure 62-21 introduced a fundamental change in the concept of depreciation. As a substitute for the classifications of Bulletin F, assets were grouped by approximately 75 general asset and industrial classifications, with a "guideline life" prescribed for each of these classes. The guideline lives were approximately 30 percent to 40 percent shorter than Bulletin F lives. Revenue Procedure 62-21 also contained a "reserve ratio test," which was designed to assure that taxpayers would not continually depreciate their assets over a substantially shorter period than their actual use and replacement.

c. Introduction of ADR - June 1971

Next, the Revenue Act of 1971 authorized the "class life asset depreciation range (ADR) system." The major provisions of this system were initially approved by the Treasury Department in June 1971, and later amplified and incorporated into the 1971 Revenue Act. At the taxpayer's election, it may apply the class life ADR system for assigning asset lives to income-

producing real or tangible personal property placed in service after 1970. The asset guideline classes, asset guideline periods, and asset depreciation ranges established under the class life ADR system are stated in Revenue Procedure 72-10.

d. Revised ADR Guidelines - March 21, 1977

For assets acquired after March 21, 1977 and prior to January 1, 1981, Revenue Procedure 83-35 contains the revised ADR guidelines. The specified upper and lower limits of the asset depreciation range are generally 20 percent below and 20 percent above the guideline period established for each class of personal property. The taxpayer may select as the asset depreciation period any period of years, that is a whole number of years, or a whole number of years plus a half year, within these upper and lower limits. Realty, however, does not have asset depreciation ranges. Accordingly for land improvements, buildings, and other real estate, the asset guideline period is also the asset depreciation period.

e. Taxpayer Election of ADR System

The system is optional with the taxpayer, who has an annual election. Each year's election applies only to assets acquired during that year. A taxpayer who elects to use the class life system for a particular year must indicate such election and the class lives used in its tax return for that year. Such election is binding on both the taxpayer and the IRS and may not be modified or revoked by either party. The taxpayer must apply the system to all eligible property acquired during the year, which falls within a class for which a class life has been established, and may not arbitrarily exclude particular items. All information relative to ADR election can be found on Form 4832 which the company is required to submit with an ADR election.

f. Asset Exclusions from ADR System

The regulations provide for exclusion of certain types of property from the ADR system. The principal exclusions permissible are for assets that are (1) subject to special rapid amortization or depreciation provisions, (2) received from related parties in a transfer that does not trigger an investment credit recapture, (3) without an ADR class, or (4) excludable property under the 10 percent used property rule (see 7-407.6).

7-405.3 Elimination of Reserve Ratio Test --- 1970

The reserve ratio test requirements are eliminated for assets placed in service after 1970, regardless of the system used for estimating useful lives. Thus, taxpayers may now compute depreciation under either the new class life ADR system or under the general rules using estimated lives, without the need for meeting the reserve ratio test.

7-405.4 The Economic Recovery Tax Act of 1981 --- ACRS

The Economic Recovery Tax Act of 1981 established the Accelerated Cost Recovery System (ACRS) for property placed in service after 1980 in tax years ending after 1980. All property other than ACRS property remains under the previous system of depreciation. Under ACRS, the costs of most tangible, depreciable property are recovered over predetermined periods generally unrelated to and shorter than useful lives. The recovery deduction for each year is determined by applying a percentage specified in the law to the unadjusted basis of the property. Following are some points meant to clarify the relationship between ACRS and depreciation computed under FAR 31.205-11.

a. Use of ACRS for Financial Accounting Purposes

FAR 31.205-11(d) and (e) provide that use of a method of depreciation for financial accounting purposes is a test of an acceptable depreciation method for contract costing. In many cases, the ACRS recovery period will not be within a reasonable range of the asset's useful life and contractors will be unable to use ACRS for either financial accounting or contract costing purposes.

b. Acceptability of ACRS for Contract Costing

(1) For contractors not subject to CAS 409 but to FAR 31.205-11, under FAR 31.205-11(d), ACRS is acceptable for contract costing if (1) ACRS is also used for non-government work in the same cost center, (2)

ACRS is used for financial accounting, and (3) ACRS is used for income tax purposes.

(2) Under FAR 31.205-11(e), if contractors subject to FAR 31.205-11 do not use ACRS for both financial accounting and tax purposes, ACRS can only be used for contract costing if (1) the ACRS recovery period is the same as the useful life and (2) ACRS is used for non-government work. In any case, allowable depreciation cannot exceed amounts used for financial accounting.

7-406 Depreciation Methods Under the General Rules

The methods for computing depreciation described in this subparagraph apply only when the class life ADR system has not been elected. When the ADR system is used, the rules are subject to certain modifications as covered in 7-407.

7-406.1 General Principles for Depreciation Methods

a. Acceptable Methods Under FAR

In general, any rational and systematic method that is consistently applied may be used in computing depreciation. Regardless of the method used, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage, during the remaining life of the property.

b. Acceptable Methods Under Internal Revenue Code

Under Section 167 of the 1986 Internal Revenue Code, the depreciation allowance on new tangible property having a useful life of three years or more is presumed to be reasonable if it is computed by use of the straight-line method, the declining-balance method, the sum of the years digits method, or other consistently applied method, subject to the limitations below.

7-406.2 Straight-Line Method

Under this method the cost or other basis of the property less its salvage value is generally deducted in equal annual amounts over the period of its estimated useful life. The straight-line method can be used for any depreciable property, new or used. Only the straight-line method can be used if the depreciation period is less than three years.

7-406.3 Declining-Balance Method

a. With the enactment of the 1954 Internal Revenue Code, taxpayers were permitted to use accelerated methods of depreciation, including the declining-balance method, at a maximum of double the appropriate straight-line rate. Subsequent amendments to the Internal Revenue Code reduced the maximum permissible rate on real estate to the straight-line rate. To be able to apply the 200 percent declining-balance method (or the sum of the years digits method), the asset being depreciated must now be new, tangible personal property with a useful life of three years or more. The following table summarizes the maximum depreciation rates permitted a taxpayer for personal and real property available at the various dates.

Type of Property	Maximum Depreciation Allowance
All property acquired before 1/1/54	150%
Tangible personal property:	
New	200%
Used	150%
Real Property:	
New - 1/1/54 to 7/24/69	200%
7/25/69 to 12/31/86	150%
1/1/87 to date	straight-line
Used - 1/1/54 to 7/24/69	150%
7/25/69 to date	straight-line

*During a brief “suspension period” from 10/10/66 to 3/9/67 the maximum permissible rate was reduced to 150 percent.

b. Special Considerations --- Salvage Value Under Declining-Balance Method

While salvage value is not deducted from the cost or other basis of the property in determining the annual depreciation allowance, an asset may not be reduced below its reasonable salvage value. (See 7-408.2c. for the 10 percent rule regarding personal property.) Where the salvage value is large, use of the double declining-balance method may require special consideration on the part of the auditor (see 7-408).

7-406.4 Sum of the Years Digits Method

The sum of the years digits method may be used only on property that meets the requirements for "twice the straight-line rate" under the declining-balance method described in 7-406.3a. above.

7-406.5 Other Methods

Any consistent method of computing depreciation may be used provided that during the first two-thirds of the useful life of the property, the depreciation deductions under any such method do not result in accumulated allowances at the end of any tax year that are greater than the total that could have been deducted under the declining-balance method. Under appropriate circumstances, "other consistent methods" include the sinking-fund method, the unit-of-production method, and the machine-hour method. The limitations on the use of the declining-balance and sum of the years digits methods apply to any consistent method used other than the straight-line method.

7-407 Depreciation Under the Class Life ADR System

7-407.1 Special Considerations for Contract Costing Under the Class Life ADR System

a. Asset lives and methods of depreciation established by the contractor in consonance with the class life ADR system are considered to be compatible with FAR 31.205-11(d)(3). This cost principle provides that depreciation costs are reasonable where a contractor uses the same policies and procedures for income tax reporting, contract costing, and financial reporting purposes.

b. However, due to unusual circumstances affecting defense contracts, use of the class life ADR system may result in inequitable charges to the government. If any inequities are found, Headquarters should be advised.

7-407.2 Limits on Depreciation Method and Rates

The taxpayer may use only the straight-line, declining-balance, or sum of the years digits methods. To eliminate potential areas of dispute between taxpayers and the Internal Revenue Service, no other method is permitted under the class life ADR system. The various rates allowable under accelerated depreciation for new and used property are the same as set forth in the table in 7-406.3a.

7-407.3 Establishing and Using Vintage Accounts

a. **Definition of Vintage Accounts**

All assets for any tax year, for which the taxpayer elects to use the class life ADR system, must be accounted for in either item or multiple-asset accounts by the year placed in service. These accounts are called "vintage accounts."

b. **Adjustment for Salvage Value**

The annual allowance for depreciation of a vintage account is determined without adjustment for the salvage value of the property in such account. Accordingly, the straight-line and sum of the years digits computations are based upon the unadjusted basis of the vintage account without reduction for salvage value. In general, the original basis of the account changes only if there is an extraordinary retirement.

c. **Change in Depreciation Method**

During the depreciation period for a vintage account the taxpayer may change from a declining-balance method of depreciation to the sum of the years digits method, and from the declining-balance method or the sum of the years digits method to the

straight-line method without the approval of the Internal Revenue Service.

7-407.4 Asset Retirements Under the ADR System

a. Retirements in General

An asset is treated as retired when it is permanently withdrawn from use in the business. Class life ADR retirements are separated into two categories: extraordinary retirements and ordinary retirements.

b. Extraordinary Retirements

Extraordinary retirements occur when assets are destroyed by fire, storm, or other casualty, or when assets amounting to more than 20 percent of the unadjusted cost or other basis of the entire account are disposed of because business activities are terminated, curtailed, or disposed of. On an extraordinary retirement, gain or loss is recognized in the year of retirement.

c. Ordinary Retirements

With respect to ordinary retirements (all others), gain or loss is generally not recognized at the time of retirement. The sales proceeds, if any, are added to the depreciation reserve of the vintage account from which the asset is retired, and the depreciation deduction is continued as if all the assets survived for as long as the life assigned to the remaining assets in the group.

7-407.5 Conventions for First-Year Depreciation of Vintage Accounts

a. General

The allowance for first-year depreciation of a vintage account is determined by applying the "modified half-year convention" or the "half-year convention." The same convention must be adopted for all vintage accounts of a tax year, but not necessarily for those of another tax year.

b. Modified Half-Year Convention

The first-year depreciation allowance for a vintage account for which the taxpayer adopts the "modified half-year convention" is determined by treating (1) all vintage account property placed in service during the first half of the tax year as placed in service on the first day of the tax year, and (2) all vintage account property placed in service during the second half of the tax year as placed in service on the first day of the succeeding tax year. Similarly, all extraordinary retirements from the account during the first half of the tax year are considered to have occurred on the first day of the tax year and all extraordinary retirements from the account during the second half of the tax year are considered to have occurred on the first day of the succeeding tax year.

c. Half-Year Convention

The first year depreciation allowance for a vintage account for which the taxpayer adopts the "half-year convention" is determined by treating all property in the account as placed in service on the first day of the second half of the tax year. All extraordinary retirements from the account are considered to have occurred on the same day.

7-407.6 Special Considerations for Acquisition of Used Assets

The class life ADR system applies to used assets as well as new assets. However, the present ranges are geared to new property. In order to remove possible inequities, the taxpayer may exclude used property from the system if the used property placed in service during any year amounts to more than 10 percent of the total. The 10 percent test must be applied separately to Section 1245 and Section 1250 property. If the 10 percent test is met and the taxpayer elects to use this exclusion, all the used property must be excluded from the system.

7-407.7 Transitional Rules for Lives of Buildings (1971-1974)

For real property there is also a transitional rule. Revenue Procedure 72-10 does not now provide a range of lives for Section 1250 assets. Instead it furnishes a single life for each class of building. In the meantime, the taxpayer is permitted to exclude Section 1250 property from the system on an asset-by-asset basis, provided that the particular circumstances show that a life shorter than the initially prescribed life is justified. This exclusion applies to real property placed in service on or after

January 1, 1971, until such time as ranges for buildings are issued or January 1, 1974, whichever is earlier. Since no ranges were issued for buildings, the exclusion expired at the end of calendar year 1973. However, PL 93-625, which addresses Section 1250 property, permits election of ADR. To determine class life of Section 1250 property, a taxpayer may use the depreciation guidelines in effect on December 31, 1970 or on the facts and circumstances of the specific asset.

7-408 Salvage Values

7-408.1 Use and Bases-Salvage Value

a. General

Salvage value is the amount the taxpayer expects to receive in cash or trade-in allowance upon disposing of the asset at the end of its useful life to the taxpayer. There is no fixed basis for determining salvage value. If an asset is customarily used for its full inherent life, salvage value may be no more than junk value.

b. Special Considerations in the Use of Accelerated Methods

(1) If it is the policy to retire assets that are still in good operating condition, the remaining salvage value at that date may represent a significant portion of the original cost basis, and therefore special consideration will have to be given when accelerated methods are used.

(2) While a contractor may use any acceptable method provided salvage values and estimated useful lives are realistic, the depreciation should not result in charging all allowable depreciation costs to the early years of use if an asset has a useful life to the contractor beyond that point. Where, for example, an asset costing $100,000 has a useful life to the contractor of four years and a remaining salvage value at the end of this period of $50,000, it is evident that use of the double declining-balance method (i.e., a rate of 50 percent), would result in writing off all the depreciation in the first year.

(3) Costing distortions of this type run counter to the basic concept of charging depreciation costs over the estimated useful life of the asset in a systematic and logical manner. They can generally be avoided by the use of a depreciation method which recognizes salvage value.

7-408.2 Under the General Rules-Salvage Values

a. Under Straight-Line and Sum of Years-Digits Methods

The contractor may use either gross salvage or net salvage in determining depreciation, and the treatment of the costs of removal must be consistent with the practice adopted. Under the straight-line and sum of the years digits methods, salvage value is subtracted from the cost or other basis before applying the annual depreciation rate.

b. Under Declining-Balance Method

Salvage value is not deducted in computing depreciation under the declining-balance method. However, see caveats specified in 7-408.1 above.

c. Ten Percent Rule on Salvage Value of Personal Property

For taxable years beginning after December 31, 1961, and ending after October 16, 1962, a taxpayer may reduce the salvage value by any amount up to 10 percent of the cost or other basis of personal property having a useful life of three years or more. This rule applies whether the property acquired is new or used. Thus, if the property has an estimated salvage value of 10 percent or less of the basis, salvage value need not be taken into account for the purpose of computing depreciation. In no event may an asset (or an account) be depreciated below a reasonable salvage value after taking into account the reduction permitted under the foregoing 10 percent rule.

7-408.3 Under Class Life ADR-Salvage Value

Salvage value is not used to reduce the basis for computing depreciation (7-407.3b). However, allowable depreciation for any vintage account may not exceed the cost or other basis of the account less the sum of (1) the reserve for depreciation, and (2) the salvage value. Thus, salvage value functions only as an overall limitation on the total depreciation allowable for property in a vintage account; however, see

caveats specified in 7-408.1 above. All information relative to ADR election can be found on Form 4832 which the company is required to submit with an ADR election. Gross salvage value must be estimated for each vintage account at the time of electing to use the class life ADR and may be reduced under the percent rule. If the taxpayer consistently follows a practice of understating salvage values, IRS will increase the salvage value to what it finds is a reasonable amount.

7-409 First-Year Write-Off of Qualifying Business Property (Section 179 of IRC)

7-409.1 General Provision

Section 179 of the Internal Revenue Code provides that under certain conditions, taxpayers may elect to write off the cost of qualifying depreciable business property (subject to the limitations discussed below) in the tax year when the property is placed in service. The taxpayer may select the item(s) and the portions of their costs to be expensed; however, the election to expense an item of Section 179 property is irrevocable. If the taxpayer elects to expense only a portion of the cost, ordinary depreciation is then computed by any of the usual allowable methods on the remaining cost, less salvage value, where applicable.

7-409.2 Limitation on Cost of Property

The cost of property which may be expensed is subject to the following limitations:

a. Dollar Limitation. The aggregate cost which may be expensed in any taxable year is limited to the dollar amounts shown below.

For taxable years beginning:	The dollar limitation is:
1986 - 1992	$10,000
1993 - 1996	$17,500
1997	$18,000
1998	$18,500
1999	$19,000
2000	$20,000
2001, 2002	$24,000
2003 and after	$25,000

b. In addition to the dollar limitation, there are certain other limitations which may further reduce the allowable amount. These additional limitations relate to business income and total value of assets placed in service during the year. The contractor's tax return may be used to verify the correct amount.

c. As indicated by these limitations, the principal objective of Section 179 is to act as a stimulant to small businesses.

7-409.3 Transactions Between Related Parties

a. The property must have been acquired from an unrelated person. If the taxpayer is a corporation acquiring the property from another corporation, the transferor must not be a member of the same affiliated group. Members of such an affiliated group are not entitled to the write-off in the first year on purchases from each other.

b. Also, the limitations on allowable expense are applied to the entire affiliated group.

7-409.4 Acceptability for Contract Costing Purposes

This first-year write-off of qualifying business property is acceptable for contract costing purposes, if it meets the criteria established by IRS.

7-410 Investment Tax Credit

The investment tax credit was eliminated on January 1, 1986. The Revenue Act of 1971 had reinstated the investment tax credit as a deduction from the Federal income tax otherwise due. The credit was a direct deduction from Federal income taxes. It is DoD procurement policy not to reduce the cost basis of the assets by the investment tax credit for the purpose of computing depreciation. Further, the credit should not be used to reduce otherwise allowable costs of government contracts. In addition, since the only value of the investment tax credit is to reduce Federal income taxes, any purchase of the investment tax credit is unallowable per FAR 31.205-41(b)(1).

7-411 Consistency in Depreciation Method

7-411.1 General Rule on Consistency

Any method otherwise permissible may be applied to a particular depreciable property "account" (which may represent an individual item or a group of related items). However, once a method is adopted for any specific "account," it must be applied consistently thereafter. In general, under IRS regulations, any change in the method of computing the depreciation allowances with respect to a particular account is permitted only with the consent of the Commissioner.

7-411.2 Depreciation Method Changes Permitted Without IRS Approval

a. Change from Declining-Balance to Straight-Line Method

A taxpayer may change, without the consent of the Commissioner, from an acceptable declining-balance method of depreciation to the straight-line method. When the change is made, the unrecovered cost or other basis (less salvage value) shall be recovered through annual allowances over the estimated remaining life determined under the circumstances existing at that time. The change to the straight-line method must be adhered to unless, with the consent of the Commissioner, a change to another method is permitted.

b. Special One-time Election for Real Property

A special one-time election is allowed for real property. For the first taxable year beginning after July 24, 1969, the taxpayer may elect to change its method of depreciating Section 1250 property from any declining-balance or sum of the years digits method to the straight-line method.

c. Vintage Accounts Under the ADR System

Where the taxpayer has set up vintage accounts under the class life ADR system it may, without the consent of the Commissioner, make the changes in methods of depreciation cited in preceding 7-407.3c.

7-411.3 Consistency by Asset, Not for All Assets

Although the method used must be applied consistently to an account, it need not necessarily be used for acquisitions of similar property in the same or subsequent years, provided such acquisitions are set up in separate accounts. A taxpayer may establish as many accounts for depreciable property as desired. It is apparent from the foregoing that although the taxpayer must be consistent in depreciation methods, this consistency relates only to the application of a particular method to a particular asset account from year to year. It does not mean that the same method must be used for all assets.

7-411.4 Consistency in Accounting and Estimating

It should also be noted that the method used for each asset account in computing incurred costs should be consistent with that used by the contractor in estimating costs for pricing purposes.

7-412 Gain or Loss on Disposition of Assets

a. Except for ordinary retirements under the class life ADR system (see 7-407.4), gain or loss is invariably realized at the time a depreciable asset is disposed of. The gain or loss will represent the difference between the asset's book value and the amount realized upon its disposal. However, that will not necessarily be the amount to be considered for contract cost purposes. CAS 409 and FAR 31.205-16 provide several bases for determining the amount of gain or loss to be recognized, as well as certain elections open to the contractor regarding cost treatment of the gain or loss. Audits of depreciation should include appropriate audit steps to assure that contract costs are determined in accordance with the requirements of CAS 409 and FAR 31.205-16.

b. Impairment losses recognized under FASB Statement No. 121, “Accounting for the Impairment of Long-Lived Assets,” effective for fiscal years beginning after December 15, 1995, are not recognized for

government contract costing. Statement of Financial Accounting Standards No. 121 requires that the carrying amount of long-lived assets, such as land, buildings, and equipment, be reduced to fair value when events or circumstances indicate that their carrying amount may not be fully recoverable. For contract costing purposes, however, contractors are required to follow the provisions of CAS 409, FAR 31.205-11, and FAR 31.205-16 regarding asset valuation and depreciation. Consequently, an impairment loss is recognized only upon disposal of the impaired asset. Until an impaired asset is disposed of, depreciation is calculated based on the asset value before any impairment loss which may have been recognized for financial reporting. Clarifying language was added to FAR 31.205-11 and FAR 31.205-16 in FAC 90-43, effective February 18, 1997. The revisions to the FAR under FAC 90-43 did not introduce any new policy as they incorporated the guidance contained in the Director, Defense Procurement's (DPP) memorandum dated January 23, 1995.

7-413 Depreciation of Leased Property

7-413.1 FAR and FASB 13

This paragraph deals with leased assets which have been capitalized using the provisions of Financial Accounting Standards Board Statement No. 13 (FASB 13), Lease Costs (see 7-200). The provisions of FASB 13 were incorporated in the DAR on September 1, 1978.

a. The auditor must be aware that different cost principles could apply to the same lease, depending on the date individual contracts were signed. Contracts signed before September 1, 1978 are subject to the provisions of the lease cost principles in effect the date the contract was signed. DCAAP 7641.6, Conversion Guide for DAR, provides the text of selected cost items in DAR 15-205 for any given date subsequent to July 1, 1976.

b. FASB 13 is not mandatory until fiscal years beginning on or after January 1, 1981. However, if the contractor elects to follow the provisions of FAS 13 for capitalized leases, regardless of the date of the lease, the provisions of DAR 15-205.9(j), effective September 1, 1978, apply.

7-413.2 FASB 13 Summary

a. Classification of Lease as Capital Lease versus Operating Lease

From the standpoint of the lessee, the lease shall be classified as a capital lease if any of the following criteria are met:

(1) The lease transfers ownership of the property to the lessee by the end of the lease term.

(2) The lease contains a bargain purchase option.

(3) The lease term is equal to 75 percent or more of the estimated economic life of the lease property. However, where the lease term begins in the last 25 percent of estimated economic life, this criterion shall not be used for purposes of classifying the lease.

(4) The present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90 percent of the excess of the fair value of the lease property over any related investment tax credit retained by the lessor. However, where the lease term begins in the last 25 percent of estimated economic life, this criterion shall not be used for purposes of classifying the lease.

b. Amortization Period

If the asset is capitalized using either of the first two criteria, the asset is amortized over the estimated economic life of the asset. If the asset is capitalized under either of the last two criteria, it is amortized over the lease term. The lease term defined in FASB 13 includes the basic term plus option periods under certain conditions. The conditions which must be part of the lease for the option period(s) to be included in the lease term are (1) lease contains bargain renewal options, (2) the lessee would have to pay a penalty so large as to assure renewal, (3) the lessee guarantees lessor's debt for the option period(s), (4) the lease contains a bargain purchase option, and (5) the lessor has the option to renew the lessee's lease.

7-414 Depreciation or Amortization of Leasehold Improvements

Improvements by the lessee are ordinarily subject to an allowance for depreciation or amortization as discussed below. The auditor should review the basis for writing off the cost of leasehold improvements.

7-414.1 Amortization versus Depreciation

Whether the lease is with a commercial concern or with the government, the cost of the improvement may be depreciated over the useful life of the improvement or amortized over the remaining term of the lease, whichever is shorter. The distinction between depreciation and amortization has some significance; the language of the regulations is generally interpreted to mean that when amortizing, the declining-balance or the sum of the years digits may not be used. When depreciating, there is no such limitation.

7-414.2 Term of the Lease

The term of the lease will include any period for which the lease may be renewed, extended, or continued pursuant to either (1) an option exercisable by the lessee or (2) in the absence of an option, reasonable interpretation of past acts of the lessee and lessor such as with respect to renewal, unless the lessee clearly establishes, past acts notwithstanding, that is improbable that the lease will be renewed, extended, or continued. Internal Revenue Code section 1.167(a)-4 and related section 1.178-1 govern the effect to be given renewal options in determining whether the useful life of the improvement exceeds the remaining term of the lease. In general, these rules establish a test for determining whether a renewal is intended, based on a comparison of the life of the improvements with the life of the lease.

7-500 Section 5 --- Insurance Costs

7-501 Introduction

a. This section provides guidance for the review of contractors' insurance programs. Considerations concerning the allocability of insurance costs are covered in Cost Accounting Standard (CAS) 416 (see 8-416). Basic considerations concerning the allowability of insurance costs are covered in FAR 31.205-19. In accordance with DFARS Subpart 242.73, joint reviews of insurance costs are conducted by DLA and DCAA at contractor locations that have $40 million or more of qualifying sales to the government during the contractor's preceding year, and the ACO determines such a review is needed based on a risk assessment of the contractor's past experience and current vulnerability (see 5-1303). A special Contractor Insurance/Pension Review (CIPR) will be performed when the contractor meets any circumstance in DFARS 242.7302 (b) that may result in a material impact on government contracts. Refer to 5-1300 for additional guidance on CIPRs. Due to the contingent nature of insurance charges (projected average loss) to government contracts, special emphasis should be placed on this element of cost when evaluating forward pricing proposals and forecasted indirect expense rates.

b. Contractors' insurance costs are generated by (1) insurance required to be carried by the terms of government contracts, (2) insurance maintained in connection with the general conduct of business, (3) insurance maintained because of statutory requirements, and (4) insurance maintained as part of employee benefits.

c. When developing an audit program, consideration should be given to the (1) materiality of the premium amounts involved for each type of insurance, (2) types and amounts of coverage included under self-insurance programs, (3) effectiveness of contractor's management of the insurance function, and (4) contractor's program for eliminating potential hazards which will cause loss.

d. Insurance costs are normally included in overhead expense pools for allocation to all benefiting cost objectives. Guidance for accumulating costs into overhead pools and selecting proper bases to allocate costs to final objectives is found in CAS 418 (see 8-418).

7-502 Mandatory Insurance Coverage and ACO Approvals

a. The clause in FAR 52.228-7 "Insurance Liability to Third Persons," is required to be included in all government contracts. Under the provisions of this clause, the contractor must maintain insurance coverage for third party contingencies such as (1) workers' compensation, (2) employer's liability, (3) comprehensive general liability (bodily injury), (4) comprehensive automobile liability (bodily injury and property damage), and (5) other types of third party liability insurance as required by the government. In addition, insurance coverage is mandatory under the provisions of FAR 28.301 when commingling of property, type of operation, circumstances of ownership, or conditions of the contract make it necessary for the protection of the government.

b. FAR 42.302(a)(2) requires the ACO to review contractors' insurance plans. The ACO must specifically approve, normally in advance, the form, extent, amount and period of insurance coverage in accordance with FAR 28.3. This approval, however, does not relieve the auditor of the responsibility of reviewing premium costs for allowability, reasonableness, and allocability to government contracts.

7-503 Optional Insurance and the Government's Contractor Insurance and Pension Reviews Program

a. In addition to the foregoing mandatory insurance coverage, contractors usually obtain other types of insurance such as health and welfare benefits for employees and various types of casualty insurance. FAR 52.228-7 does not require the contractor to submit these types of coverage to the contracting officer for specific approval unless requested.

b. The government's general survey and review of a contractor's insurance program, which may be performed under FAR 42.3,

may be limited to verifying that the contractor's insurance program provides appropriate protection in consonance with the types of risks involved. Such a review, by itself, does not constitute a sufficient basis for accepting related premium costs. Therefore, where insurance costs and the government's participation therein are material, the auditor should review the contractor's insurance programs to the extent required to establish whether the costs are necessary, reasonable, and allocable to government contracts.

7-504 Allowability and Allocability

a. Where such benefits are not an incidental part of a pension plan, insurance programs may be established to provide current or retired employees with fringe benefits such as health, medical services, and death benefits. The criteria for the allowability and allocability of such costs is governed primarily by FAR 31.205-6, Compensation, and CAS 415, Deferred Compensation, rather than by FAR 31.205-19 Insurance and Indemnification. Payments under these programs can constitute either current or deferred compensation. Deferred compensation is allowable only to the extent it, together with all other compensation paid to the employee, is reasonable in amount, paid pursuant to a good faith agreement between the employee and the contractor, and consistently applied in future periods. Costs which are unallowable under other paragraphs of FAR 31.2, shall not be allowable under FAR 31.205-6 or CAS 415 solely on the basis that they constitute personal compensation.

b. CAS 416 provides criteria for the measurement of insurance costs, the assignment of such costs to cost accounting periods, and the allocation to final cost objectives. Briefly stated, the standard requires that allocation of insurance costs to cost objectives shall be based on the beneficial or causal relationship between insurance costs and the cost objectives. It also specifies that the amount of insurance cost to be assigned to a cost accounting period is the projected average loss for that period plus insurance administration expenses incurred in the same period.

7-505 Purchased Insurance Cost

a. Purchased insurance can usually be obtained from commercial carriers for all types of insurance. Generally, contractors purchase insurance at fixed premiums or advance premiums which are subject to retroactive adjustments on the basis of claim experience. The auditor's review should include an appropriate examination of individual insurance policies for indications of excessive or duplicated coverage or unrealistic premium rates. During periods of high competition within the insurance industry, premium costs diminish. Therefore, the auditor should ascertain whether the contractor solicits competitive quotations periodically to determine that downward price trends are reflected in the premiums paid.

b. The government's participation in premium costs should be commensurate with the benefits received. Also, contracts should share in dividends and other credits received by the contractor, in proportion to the participation in gross premium costs. Insurance provided by captive insurers (owned by or under the control of the contractor) is considered self-insurance and must comply with the self-insurance provisions of CAS 416. Premiums paid to fronting insurance companies (companies not related to the contractor which reinsure with a captive insurer) should not exceed (excluding a reasonable service charge) the amount which the contractor would have been allowed had it contracted with a competitive insurer.

7-506 Self-Insurance Cost

7-506.1 Contractor Elections for Self-Insurance

a. Contractors may elect to provide coverage for certain risks from their own resources under a program of self-insurance. The contractor's decision to self-insure should be based on a determination that the coverage can be provided by self-insurance at a cost not greater than the cost of obtaining equivalent coverage from an insurance company or State fund. If purchased insurance is available, the charge for any self-insurance coverage

plus insurance administrative expenses shall not exceed the cost of comparable purchased insurance plus associated insurance administrative expenses (FAR 31.205-19).

b. Generally, the contractor will rely on self-insurance to cover ordinary risks and losses and, at the same time, maintain various forms of purchased insurance to cover major risks and catastrophic losses. For example, under a self-insured employee group health and survivorship plan the contractor usually will limit its self-insurance to providing hospital, surgical, and medical expenses and, at the same time, purchase insurance covering life, accidental death and dismemberment, disability income benefits, and dreaded disease coverage.

7-506.2 Approval for Self-Insurance

In accordance with FAR 28.308, self-insurance programs must be submitted to the contracting officer for approval when 50 percent or more of the self-insurance costs to be incurred at a segment will be allocated to negotiated government contracts and the self-insurance costs at the segment are expected to be $200,000 or more annually. This same section of FAR provides that programs of self-insurance covering any kind of risk may be approved when examination of such programs indicates that their application is in the best interest of the government. Self-insurance for risks of catastrophic losses, however, is not allowable in accordance with FAR 31.205-19(e).

7-506.3 Self-Insurance Administration Costs

a. A contractor may administer its self-insurance program either by employing personnel possessing the necessary technical skills, contracting with one or more insurance firms to provide the necessary services, or both. Since self-insurance costs should not exceed the cost charged by a commercial carrier, it is important that all costs be readily identifiable in the accounts.

b. In addition to losses related to claims, the cost of operating a self-insurance program should include the salaries of employees in the company's insurance department, any outside services, and all of the incidental expenses incurred such as use and occupancy, telephone, and supplies. The contractor should make periodic comparisons between the actual cost it has incurred and the cost of premiums it would have paid to an insurance company if the coverage had been purchased.

7-506.4 Periodic Charges for Self-Insurance

a. Under a self-insurance program, the contractor shall make a charge for each period which represents the projected average loss for that period. The self-insurance charge plus insurance administration expenses may be equal to, but shall not exceed the cost of comparable purchased insurance plus the associated insurance administration expenses. The contractor's actual loss experience shall be evaluated regularly and self-insurance charges for subsequent periods shall reflect such experience in a similar manner as would purchased insurance. The actual loss shall be measured by actual cash value of the property destroyed, amounts paid or accrued to repair damage, amounts paid or accrued to estates and beneficiaries, and amounts paid or accrued to compensate claimants, including subrogation. Actual losses may be used to determine self-insurance costs (1) when probable losses will not differ significantly from the projected average loss for that period and (2) under self-insurance programs for retired persons.

b. CAS 416.50(a)(3)(ii) provides that if a loss has been incurred and the amount of the liability to a claimant is fixed or reasonably certain, but actual payment of the liability will not take place for more than one year after the loss is incurred, the amount of the loss to be recognized currently shall not exceed the present value of the future payments. These future payments are to be computed using a discount rate equal to that prescribed for settling such claims by the State having jurisdiction over the claim or if no such rate is prescribed by the State, then the current Treasury Rate is to be used to

discount the liability. Because many State rates are unrealistically low, using such rates to discount self-insurance liabilities will result in excessive contract costs. FAR 31.205-19(a)(3) limits the computation of the present value of future payments to an amount computed using as a discount rate the interest rate determined by the Secretary of the Treasury pursuant to 50 U.S.C. App. 1215(b)(2) in effect at the time the loss is recognized.

7-506.5 Broker's Quotes Used to Estimate Self-Insurance Costs

a. The use of broker quotes is an estimating technique in which contractors obtain a quote from an insurance broker and use it to represent their projected average loss. They do not actually purchase the insurance but only use the quote to determine the costs that would have been incurred if the insurance coverage had been purchased. Use of these quotes to estimate self-insurance costs for a period is generally considered an acceptable estimating technique to determine the projected average loss for the period under CAS 416.50(a)(2)(i), which states "If insurance could be purchased against the self-insurance risk, the cost of such insurance may be used as an estimate of the projected average loss; if this method is used, the self-insurance charge plus insurance administration expenses may be equal to, but shall not exceed, the cost of comparable purchased insurance plus the associated insurance administration expenses. However, the contractor's actual loss experience shall be evaluated regularly, and self-insurance charged for subsequent periods shall reflect such experience in the same manner as would purchased insurance." Many times quotes may contain statements that actual loss experience was considered but, in reality, there is no relationship between the quoted amount and the loss experience. It is imperative that an evaluation of self-insurance costs based on broker quotes be reviewed for reasonableness, i.e., that the actual loss experiences of the contractor has been included as one of the factors in the quote used to measure the self-insurance charge, and that the quote is based on all pertinent data regarding the contractor's potential liability for the insurance coverage. Contractors should be required to adequately demonstrate that amounts claimed for self-insurance costs based on broker quotes consider these factors.

b. In addition to requiring that the quoted amounts reflect actual experience and potential liability, contractors who use this method should be required, at a minimum, to obtain competitive quotes and to demonstrate that the use of broker quotes is also in accordance with FAR 31.205-19(a)(2)(i) in that they are based on sound business practices and the rates and premiums quoted are reasonable under the circumstances. The contractor's self-insurance program, including the use of broker quotes, should be approved by the ACO and should be in accordance with the contractor's policies and procedures and insurance manual. The contractor should maintain the difference between the estimated and actual cost in a reserve account. The account should be adjusted annually to reflect changing reserve requirements as determined by an actuary, and any adjustment should be reflected in the next year's estimated projected average loss.

7-506.6 Audit Considerations

When reviewing a contractor's self-insurance program, the auditor should evaluate (1) the types of risks covered and the nature of the contractor's risk assumption, (2) comparative costs of the program, including administrative and corollary costs, (3) effectiveness of the contractor's claims procedures, (4) equity of the accounting treatment of self-insurance costs from the standpoint of the plan of funding and allocation of costs, and (5) maintenance of the reserve in accordance with CAS 416. In reviewing the administrative and corollary costs, the auditor must assure that all appropriate costs have been taken into account and that self-insurance is economical. It should also be ascertained whether the contractor has a staff that is qualified to process claims and whether the system has internal controls that are adequate to

assure accurate payment of claims to employees or third parties

7-507 Workers' Compensation and Employer Liability Insurance Cost

7-507.1 General

a. Workers' compensation insurance protects an employer against the liability imposed by workers' compensation laws to pay benefits and furnish medical care to employees for injuries and occupational diseases attributable to their employment. Employer's liability insurance covers claims for damages relating to special types of work and injuries or occupational diseases not covered under the State laws. These types of liability coverage are not a form of personal compensation to the employee, and their allowability should be considered under FAR 31.205-19. FAR 28.307-2 requires contractors performing under government contracts to carry employer's liability coverage in the minimum amount of $100,000, except in States with exclusive or monopolistic workers' compensation funds which do not permit the writing of such coverage by private carriers, or except in those States where the Workmen's Compensation Act constitutes the exclusive remedy of employees against employers for all injuries or diseases relating to their work. The cost of workers' compensation is affected by geographical location and the hazards of the particular work task. Therefore, the contractor's method of allocating the expense to burden centers should recognize this relationship in order to allocate the premium cost equitably.

b. Each State has its own workers' compensation laws. Accordingly, auditors should determine that contract charges for workers' compensation are in accordance with laws of the contractor's applicable state of business. Premium rate guidelines are published by the National Council on Compensation Insurance based on accident experience throughout the Nation's businesses and industries. Workers' compensation rates are based on employee occupational classifications and on covered payroll. When evaluating such rates, the auditor should determine that all applicable labor categories are used to estimate the insurance premium. The failure to include all labor categories can result in overstated premiums.

c. Usually, an estimated premium is charged when the workers' compensation policy is written. After the policy expires, a payroll audit is made. The actual premium is then determined and adjustments made. Auditors should be alert to specific policy clauses. Some policies call for interim adjustments, such as adjustments to the estimated premium for the actual amount of labor dollars incurred on a monthly basis.

7-507.2 Retrospectively Rated Plans

a. Many workers' compensation policies are retrospectively rated. The initial premium is adjusted (up or down) at a later date, depending on incurred losses. Although there are many variations of retrospectively rated plans, an insurance company will normally go through the following steps when billing a customer under a retrospectively rated policy:

(1) The policy is written using the State bureau rates. The retrospective endorsement and provisions are attached to the policy.

(2) The premium is billed based on payrolls reported to insurance company.

(3) After the policy expires, the insurance company audits the actual payroll data. The insurance company's audited payroll amount is used to develop the standard premium used in the retrospective adjustment.

(4) Actual claims are valued by the claim department six months after the policy expires. The time lag permits accurate valuation of open cases and allows time for settlement of outstanding claims.

(5) The loss and payroll figures are then used by the insurance company to calculate the first retrospective rating adjustment.

(6) Subsequent retrospective adjustments may be made at 1- year intervals to reflect the developments on open cases.

b. The retrospective rating billing procedures should give the auditor an indication of some of the documentation available to evaluate the allowability and allocability of insurance costs.

c. Where retrospectively rated plans are used, insurance companies may hold re-

serves. Reserves provide for anticipated payouts after the close of the policy year. The auditor should review the written purpose of the reserve to determine that the reserve is not an unallowable deposit. The auditor should evaluate the support for the reserve and the fluctuations within the reserve. Usually, pending lawsuits, known claims, and legal representations from attorneys are included as part of the supporting reserve package. The same documentation should be available for reserves under both a purchase plan and a self-insurance plan.

7-507.3 National Defense Projects Rating Plan

a. Ordinarily, a retrospective rating plan will result in the lowest net cost for workers' compensation insurance. However, the National Defense Projects Rating Plan described in DFARS 228.304 is intended to provide this insurance to an eligible contractor at even lower costs. The savings result partly from covering not only the employees of the prime contractor, but also those of all of its subcontractors performing work at the same location.

b. The rating plan may be applied to cost-reimbursement type contracts and, in appropriate cases, to fixed-price contracts with price redetermination provisions. A defense project is eligible for application of the plan when (1) eligible government contracts represent, at inception of the plan, at least 90 percent of the payroll for total operations at the specific locations of the project; and (2) the annual premium for insurance is estimated to be at least $10,000. The plan is available in all States except Arizona, California, Nevada, North Dakota, Ohio, Oregon, Washington, West Virginia, and Wyoming.

c. Notify the contracting officer of any instance where an eligible contractor's workers' compensation insurance has not been placed under this plan.

7-507.4 War Hazard Insurance --- War Hazard Compensation Act

a. The Defense Base Act extends workers' compensation coverage to various classes of employees engaged in work outside the United States. Where the Defense Base Act applies, the benefits of the Longshoremen's and Harbor Worker's Compensation Act are extended through the operation of the War Hazard Compensation Act, as amended (42 U.S.C. 1701 et seq.), to afford protection to employees against the hazards of war (injury, death, capture, detention). In general, war hazard benefits are payable when the claim cannot be presented under the workers' compensation coverage because the event which caused the claim was attributable to an act of war. Benefits of the War Hazard Compensation Act are provided to all eligible employees at no cost to the employer by the Bureau of Employee's Compensation, Department of Labor.

b. Upon recommendation of the officials concerned, as prescribed in DFARS 228.305(d), the Secretary of Labor may waive the applicability of the Defense Base Act with respect to any contract, subcontract, or classification of employees. Waivers of the Defense Base Act should be considered where foreign employees are subject to compensation laws or comparable provisions of their country. In these instances, the benefits provided by the country of the employed foreign national are less than the benefits offered under the Defense Base Act and consequently the ultimate cost to the government would be less. In addition to the benefits provided under the War Hazards Compensation Act, a contractor may be required to provide supplemental war hazard insurance in order to induce employees into hazardous areas. This supplemental coverage is generally limited to U.S. citizens and professional-type foreign nationals.

7-507.5 War Hazard Insurance --- FD-712 Program

The FD-712 War Hazard policy is a unique program for supplemental benefits offered by a commercial insurance company. The insurance is written directly with contractors, subcontractors, and grantees of the military departments, Department of State, Agency for International Development, or any other department, agency, or subdivision of the

Federal government which is eligible to participate in this insurance (and is accepted in writing by the insurance company for this coverage). The FD-712 program provides benefits up to $50,000 at stipulated rates as indemnity for loss of life, limb, sight, or permanent total disability. Under the Retrospective Premium Agreement, the total premiums paid are adjusted to reflect actual losses, accumulation of a stabilization fund for the payment of future losses, accumulated interest, and incurring States' premium taxes. Any premium in excess of that calculated in the premium adjustment is payable to the Treasurer of the United States. Upon termination of the policy and after all outstanding losses have been settled, the final premium is determined and any determined excess premium will be paid to the Treasurer of the United States.

7-508 Liability Insurance Cost

7-508.1 General Comprehensive Liability Insurance

FAR 28.307-2(b) requires general comprehensive insurance with minimum limits of $500,000 per accident. Third party property damage liability insurance ordinarily is not required under government contracts. However, where a commingling of operations permits property damage coverage to be obtained at a nominal cost to the government under insurance carried by the contractor in connection with the general conduct of its business, the participation in such insurance cost may be deemed in the best interest of the government.

7-508.2 Automobile Liability Insurance

For automobile liability, FAR 28.307-2(c) requires coverage with minimum limits of $200,000 per person and $500,000 per accident for bodily injury and $20,000 per accident for property damage. This coverage is required in a comprehensive policy covering the operation of all vehicles used in performance of government contracts.

7-508.3 Aircraft Liability Insurance

When aircraft are used in performance of government contracts, FAR 28.307-2(d) requires public liability coverage with minimum limits of $200,000 per person and $500,000 per accident for bodily injury and a minimum limit of $200,000 per accident for property damage. Also, passenger liability bodily injury limits of $200,000 per passenger is required, with an aggregate minimum limit equal to total number of seats or total number of passengers, whichever is greater.

7-508.4 PL 97-12 Prohibition of Certain Insurance Costs

Public Law 97-12 prohibits payments for commercial insurance to protect against the contractor's own defects in materials or workmanship incident to the normal course of construction. The type of insurance covered by this public law should not be confused with professional liability insurance, such as that maintained by architects and engineers covering liabilities to third parties arising from errors, omissions or negligent acts. The public law is not intended to cover liability insurance for damages (third party suits) arising as a result of the use of the product. Rather it is intended to make unallowable costs to repair defects in materials or workmanship. Accordingly, the public law cannot be cited as a basis for questioning costs of third party liability insurance. However, this does not mean that professional liability insurance may not be questionable due to lack of allocability to government contracts in accordance with 7-508.5, Professional Liability Insurance.

7-508.5 Professional Liability Insurance

a. Professional liability insurance (also referred to as architects and engineers or errors and omissions insurance) protects against damages to clients or third parties resulting from professional errors or judgments. The cost of professional liability insurance is allowable, subject to tests of reasonableness and/or allocability. In performing these tests, if the cost of insurance is material, the auditor should

review the policy coverage and claims and loss experience.

b. Reviewing policy coverage is the first and most important step in determining allocability and reasonableness. If a contractor's liability insurance policy provides coverage for its general practice, allocation of premiums to all contracts through overhead or general and administrative expense is usually acceptable. However, if this policy is written to provide unique liability coverage for a particular business segment or product, costs should be directly allocated to the benefiting cost objective. Where a plain reading of the policy does not clearly establish the general nature of the coverage or the auditor has reason to believe that unique liability coverage is involved, an examination should be made of the types of services being rendered to both the government and commercial customers. If the services (service primarily refers to discipline, such as architectural, mechanical, civil engineering work, etc.) are essentially similar, a broad-based allocation is acceptable. On the other hand, where the services are dissimilar, examination should be made of the claims and loss experience as explained below.

c. If the costs are material, and the contractor does not provide the same service to the government as to the commercial customers, then the auditor should review claims and loss experience. (Claims are always defined in the policy.) This could give the auditor some added insight into the applicability of policy coverage as well as allocability of costs. Items reviewed should include a number of settled and pending claims, whether they apply to government or commercial contracts, and the dollar amounts. The auditor must exercise judgment in selecting a time frame to review claims history relevant to the costs under audit.

(1) The existence of claims on either government or commercial contracts alone is not conclusive as to how premiums should be allocated. However, a significant number of claims arising because of one particular product, segment, customer, etc., may indicate the need for a more thorough review of the nature of the service or projects causing the claims disparity and consideration of a more appropriate allocation base.

(2) The review of claims and loss experience should only be used to challenge the broad-based allocation of costs where the auditor can determine that the insurance is primarily purchased to protect against liability unique to particular types of services, components, or projects.

d. In determining premiums for a contractor, the insurance carrier usually considers such factors as location of the business, size of the firm (billing/revenue), professional discipline(s) being practiced, and loss experience. The proper allocation of premium costs should be determined primarily by the terms of the coverage where services provided are essentially the same for all final cost objectives. While claims and loss experience may vary considerably from year to year, and between classes of businesses (i.e., government vs. commercial), such experience should not be used to challenge the broad based allocation of premium cost unless it can be determined that the services provided are essentially dissimilar and hence the risk of claims is proportionally greater for certain services than others.

7-508.6 Product Liability

a. In the normal course of doing business, a contractor will insure itself against bodily injury to others, and damage to, or loss of, property of others arising from the failure of its products. A common basis for this premium is sales. The cost applicable to military versus commercial products should be easily determinable unless an average composite liability rate is used for both.

b. Such a composite rate may be inequitable. It should be discussed with government contract management personnel and the contractor for the purposes of obtaining separate rates for military and commercial products. For the most part, major defense contractors have negotiated separate rates, but the rates for military products still may be excessive in relation to the actual losses resulting from failure of military products.

c. Auditors should ascertain that the contractor has conscientiously attempted to negotiate with its insurance carrier a separate military products rate commensurate

with the loss experience of such products. Whenever premium rates are not commensurate with loss experience, obtain the views of the government contract management official relative to rating the coverage. Further, ensure there is no absorption by government contracts of premiums solely applicable to a contractor's commercial products.

d. Audit evaluations of product liability insurance premium allocations should, as a minimum, include an analysis of the government and commercial loss experience for a representative period. Government premium breakout allocations in excess of the average government loss experience may be unreasonable. If an excess exists, additional audit considerations would include (1) comparisons of premiums and allocation bases with comparable companies; (2) requesting detailed explanations from the insurance carriers on the basis of the premium split between commercial and government and a breakdown of risk exposure; and (3) if possible, obtaining independent quotes from other insurance carriers on government exposure only. Where aircraft product liability insurance is allocated on a sales base to government contracts, auditors should specifically review for compliance with CAS 403.40(b)(4)and 403.60(b)if a home office, and CAS 410.50(g)(2) if an operating segment. Where a breakout between commercial and government is not provided, exceptions to proposed costs should be considered as noncompliances with the standards as well as FAR 31.201-4(b). Advance agreements between the government and contractors on acceptable government premium costs should clearly state the basis of the agreement and how future costs will be allocated.

7-508.7 Insurance for Government-Owned Property

FAR 31.205-19(a)(2)(iv) states "Costs of insurance for the risk of loss of or damage to government property are allowable only to the extent that the contractor is liable for such loss or damage and such insurance does not cover loss or damage that results from willful misconduct or lack of good faith on the part of any of the contractor's directors or officers or other equivalent representatives." Accordingly, where the risk of loss is not the responsibility of the contractor, the cost of insurance coverage should be questioned.

7-509 Casualty Insurance Cost

7-509.1 Fire and Comprehensive Casualty Insurance

Fire insurance provides for reimbursement to the insured for losses resulting from the causes enumerated within each policy. Most of these policies will include hazards in addition to fire, such as hail, windstorm and earthquake. When such is the case, the policy is usually referred to as a multiple peril or comprehensive policy. These policies ordinarily cover buildings, capital equipment, inventories, and supplies belonging to the insured. With respect to buildings, rating bureaus established under the various State insurance departments are responsible for setting the rates for each type of building. Self-insurance is most appropriate where a contractor's plants are isolated and scattered over a wide area, thereby dispersing the risk.

7-509.2 Fidelity Bonds

Fidelity bonds provide protection against defalcation and theft by employees, especially those in positions of trust. The auditor should become familiar with the circumstances involved in any claim for loss, inasmuch as it indicates a failure of internal control.

7-509.3 Insurance on Lives of Officers and Owners

Costs of insurance on lives of officers, partners, or proprietors are allowable only to the extent that the insurance represents additional compensation [FAR 31.205-19(a)(2)(vi)]. The auditor should review the insurance policy to determine who is the beneficiary on the policy. If the company or its owners are beneficiaries, the costs are unallowable; if the executives family or estate are beneficiaries, the costs are allowable if the total compensation paid to the executive is reasonable.

7-510 Split-Dollar Life Insurance Cost / Deferred Compensation Plans

7-510.1 General

a. Split-dollar life insurance plans provide for a sharing between the employer and the employee of the premium payments, ownership, cash values, and the death benefits (hence the name split-dollar life insurance). These insurance plans are used by some contractors to reward executives and key employees for their performance or to induce them to remain with the company. Typically, the employer pays the insurance premiums on the life insurance policy on the employee's life and takes a collateral assignment (i.e., interest in the policy) equal to the premiums it pays. The employee owns the policy and designates the beneficiary. If the employment ends or the insurance policy is terminated, the employee is required to reimburse the employer for the aggregate premiums paid by the employer.

b. Some plans include a separate but interrelated deferred compensation agreement that provides the employee with deferred compensation in the same amount as the aggregate premiums the employee (or his/her beneficiaries) must reimburse the employer. The deferred compensation is generally payable to the employee at the same time that the employee or his/her beneficiaries are required to reimburse the employer.

c. There is variability in the terms and conditions of split-dollar life insurance plans. The guidance provided in this section is based on the most common plans. It is important that auditors carefully review the terms and conditions of the individual plans and make appropriate adjustments for the individual situation, or seek additional guidance from their regional office if necessary.

7-510.2 Premiums Paid by the Company

The proper accounting treatment of premium payments for split-dollar life insurance is addressed in Financial Accounting Standards Board Technical Bulletin No. (FAST) 85-4, Accounting for Purchases of Insurance. FAST 85-4 states in part, "The amount that could be realized under the insurance contract as of the date of the statement of financial position should be reported as an asset." Under a typical split-dollar life insurance plan where the employee owns the policy and has an unavoidable obligation to reimburse the contractor for the amount of the insurance premiums, the employer would receive from the employee an amount equal to the aggregate premiums paid to the insurance company. Therefore, the employer should recognize the annual premium paid to the insurance company as an asset, not an expense. The annual premiums are essentially an interest free loan from the contractor to the employee, not an element of the total cost of a contract as defined in FAR 31.201-1, Composition of Total Cost, and should be questioned if claimed.

7-510.3 Cost Paid under the Interrelated Deferred Compensation Agreement

a. Deferred compensation costs incurred under the employer/employee agreement which provides the employee with deferred compensation equal to the aggregate premiums the employee must reimburse the employer under the terms of a split-dollar life insurance plan should be evaluated in accordance with FAR 31.205-6(k). Under that provision, deferred compensation is allowable if it is based on current or future services and assigned and measured in accordance with CAS 415, Accounting for the Costs of Deferred Compensation.

(1) Based on Current or Future Services. Although the terms of the interrelated deferred compensation agreements may not explicitly state so, these agreements provide essentially a series of annual awards (each equal to the annual premium) to be paid at some future date, for services provided in the period in which the annual life insurance premium is paid. That is, each year, the employee is awarded deferred compensation equal to the annual insurance premium paid by the employer for that period, to be paid upon retirement, death, or other circumstances as stipulated in the agreement. Therefore, the deferred compensation to be paid under the terms of a typical plan is based on current or future

services and meets the allowability criteria at FAR 31.205-6(k)(1).

(2) Assigned in Accordance with CAS 415. CAS 415.40(a) requires that the costs of the deferred compensation be assigned to the cost accounting period in which the contractor incurs an obligation to compensate the employee. CAS 415.50(a) provides six conditions that must be met before a contractor is deemed to have incurred an obligation for the cost of deferred compensation. If the applicable conditions are met in the accounting period in which the contractor pays the annual life insurance premiums, the cost of each annual award is assignable to that period. If these conditions are not met, CAS 415.50(b) requires that the cost be assigned to the period in which the compensation is paid. The auditor should review the terms of the plan to determine if these conditions are met.

(3) Measured in Accordance with CAS 415. The assignable cost for each year is measured as the present value of the annual award (i.e., an amount equal to the annual premium) discounted from the estimated date of payment. Under most plans, the estimated date of payment will be the estimated date of retirement. CAS 415.50(d)(5) provides that the discount rate used to calculate the present value is the Treasury rate used to compute cost of money factors (see 8-414.2). To illustrate, assume that the annual deferred compensation award (which is equal to the annual premium payment) is $30,000; the employee is expected to retire in ten years; and the cost of money rate is 8 percent. The amount assignable to the current year is $13,896 ($30,000 discounted for ten years at 8 percent).

(4) Adjustments for Forfeitures Required by CAS 415. The auditor should also verify that the contractor has complied with CAS 415.50(d)(7), which requires that any forfeiture which reduces the employer's obligation for payment of deferred compensation be a reduction of contract costs in the period in which the forfeiture occurred. The amount of the contract cost reduction for a forfeiture is the amount of the award that was assigned to prior periods, plus interest compounded annually, using the same Treasury rate that was used as the discount rate at the time the cost was previously assigned.

b. Deferred compensation payments made in conjunction with a split-dollar life insurance plan are also subject to the reasonableness criteria of FAR 31.205-6(b), including paragraph (b)(2)(i) which requires that special consideration be given to the evaluation of the reasonableness of the compensation if the company is a closely held corporation, partnership, or sole proprietorship and the individual participating in the plan is the owner or a partner.

7-600 Section 6 --- Pension Costs

7-601 Introduction

This section provides guidance for the audit of pension costs. Basic considerations concerning the allocability of costs of retirement and pension plans are found in Cost Accounting Standards (CAS) 412 and 413 (see 8-412 and 8-413). Basic considerations concerning the allowability of costs of retirement and pension plans are in FAR 31.205-6. In accordance with DFARS Subpart 242.73, joint reviews of pension costs are conducted by DLA and DCAA at contractor locations that have $40 million or more of qualifying sales to the government during the contractor's preceding year and the ACO determines such a review is needed based on a risk assessment of the contractor's past experience and current vulnerability. A special Contractor Insurance/Pension Review (CIPR) will be performed when the contractor meets any circumstance in DFARS 242.7302(b) that may result in a material impact on government contracts. If a CIPR or special CIPR are not performed, the only formal review of pension cost will be a DCAA audit. Therefore, it is essential that the auditor perform a risk assessment to determine the need for a CIPR or special CIPR. Refer to CAM 5-1300 for additional guidance on CIPRs. See 9-703.8 for guidance on evaluation of pension costs in contractor indirect cost estimates.

7-602 Definitions and Terms

Due to the complexity of this audit area and the unique terms used in the laws and regulations regarding pension plans, auditors should have a working knowledge of the terms and definitions found in CAS 412 and 413. The auditor should always exercise due care in selecting terms to describe specific issues when reporting the results of audit of pension plans.

7-603 Approval and Review Requirements

a. Most pension plans are submitted to the Internal Revenue Service (IRS) for approval. Generally, the IRS will issue a "favorable determination letter" if the plan meets required qualifications. A plan that satisfies the requirements of section 401(a) of the Internal Revenue Code (IRC) is considered to be a qualified plan. If a plan is qualified, the sponsor is entitled to claim contributions to the plan as tax deductions, while the plan participants are not required to claim earned benefits until they are received. If a contractor's plan is qualified, a copy of the "favorable determination letter" should be in the permanent files. Some of the more important plan qualification requirements are (1) the employer's contributions to the plan must be irrevocably funded, (2) the plan must be intended to be a permanent plan and must be in writing and communicated to the employees, and (3) the plan must not discriminate either in contributions or benefits in favor of officers, supervisors or highly compensated employees. Approval of a pension plan by the IRS does not require audit acceptance of the cost of the plan.

b. The auditor should notify his or her regional office in writing when a contractor has a pension plan in effect that will require assistance of the regional office in evaluating the pension plan costs. In the event of a transfer of audit cognizance to another FAO, the relinquishing FAO should prepare a detailed summary of the current pension issues for the FAO that has assumed responsibility for the pension audits. The summary should include data on the change in accumulated assets and liabilities in employee benefit funds as a result of any mergers, acquisitions, and divestitures. In order to ensure adequate audit coverage of transferred pension fund assets and liabilities, it is important that FAOs cognizant of buyer and seller contractors maintain close coordination and communication in oversight of contractors' accounting for pension cost charged to government contracts. See 1-502 for additional comments on transfer of audit cognizance.

c. When assistance or guidance is needed by the regional office on a plan or any of its features, the matter should be referred to the Assistant Director, Policy and Plans.

7-604 Types of Pension Plans

a. There are various types of pension plans. Each type will have a formal written document describing details of the plan. Employers will also usually have explanation and announcement booklets, prepared for employees, that provide additional information about each plan.

b. Plans can be classified as insured or trusteed, defined benefit or defined contribution, contributory or noncontributory. Some plans will be a combination of these classifications.

c. A plan is called an insured type if its funding agency is an insurance company. Here, the plan sponsor makes contributions to an insurance company, and the insurance company issues various types of contracts to provide the designated plan benefits. Some insurance arrangements provide investment services only, without guarantees of benefits, investments or earnings.

d. A plan is called a trusteed type if its funding agency is a trust fund. Contributions go to the trustees who in turn invest and manage the assets and pay the stated benefits. The trustees can be third parties, such as banks, or individuals, including employees of the contractor.

e. A plan is called contributory if the participants are allowed (or required) to make contributions to it, usually in the form of payroll deductions. A noncontributory plan does not permit contributions by plan participants.

7-605 Considerations in Evaluating Acceptability of Claimed Pension Plan Costs

7-605.1 Reasonableness of Costs of Plan and Overall Compensation of Participating Employees

a. A comparison of the ratios of current and past service costs of a given contractor's plan to the total basic payroll of participants (or to the total basic payroll of all employees), with similarly calculated ratios of similar industries in the area, will furnish a yardstick for the measurement of the overall reasonableness of the costs of the plan. While these results may not be conclusive, they may be indicative of plans which warrant a more thorough analysis of the factors affecting costs.

b. Pension Fund Valuation and Rate of Return.

(1) There are two methods used to accumulate pension plan assets. One method is to purchase insurance contracts. A second method is to make contributions to a trust fund. CAS 413.40(b) requires the valuation of all pension fund assets using a valuation method which takes into account unrealized appreciation and depreciation of the assets. A realistic value must be placed on the fund for proper determination of funding requirements. The current value or a method that takes into account current value should be used. When plan asset values rise, funding contribution requirements will usually fall. The contractor should compute this impact on the pension expense. In many cases, contractors will make this assessment prior to the issuance of the actuarial report on the plan. In rising financial markets, the auditor needs to insure that the government receives the full benefit of the reduced costs in the pricing and costing of all contracts (cost type and fixed-price type). Consequently, contractor price proposals, indirect cost rate forecasts, and forward pricing rate agreements need to be evaluated to determine if they contain the reduced forecasts due to lower pension expense.

(2) The interest rate assumption is an extremely important factor in computing current contribution requirements and should be compared with the actual or approximate rate of return on the securities in the fund. If it is not reasonably close, then appropriate evaluation of this factor should be performed by the auditor.

(3) It is not intended that auditors should attempt any significant recalculations of pension plan rates, as this can best be done by the actuaries. However, information on the market value of the fund and the rate of return should be available from the contractor.

7-605.2 Other Considerations in Evaluating Acceptability of Claimed Costs

a. Allocation and Assignment of Costs

(1) Pension costs accorded audit approval under government contracts should

bear a reasonable relationship to the pension costs generated by eligible employees engaged in work under such contracts. The allocation basis of pension plan costs should recognize differences of employment status, within practical limitations, between employees engaged in government work and employees engaged in other than government work. Further discussion of the allocation of costs is included in the paragraphs on past service costs and reversionary credits (see 7-605.2c).

(2) Pension costs should be assigned to cost accounting periods in accordance with sound accrual accounting practices. Pension costs are often computed for a plan year that does not coincide with the contractor's cost accounting period. A potential problem arises if the contractor assigns such costs to a single cost accounting period, rather than prorating the costs between the two contemporaneous periods. This practice would be in noncompliance with CAS 406.50(b), which requires accrual practices to be "Appropriate," because it would not be in accordance with generally accepted accounting principles (see 8-406). This practice would also be in noncompliance with CAS 412.40(a)(1) and (c) (see 8-412), which requires pension costs to be computed for a cost accounting period. Contractors' accrual practices for pension cost should be reviewed, and material noncompliances should be reported to the contracting officer. See also 6-608.3b.(1).

b. Allowability of Nonqualified Pension Plan Costs

A nonqualified pension plan is any pension plan other than a qualified pension plan (see 7-603(a)). The pay-as-you-go cost method is used on nonqualified plans and is a method of recognizing pension costs only when benefits are paid to retired employees or their beneficiaries. However, as discussed below, nonqualified plans are not limited to the use of the pay-as-you-go cost method.

Following are key dates and associated rules governing the allowability of nonqualified pension plan costs for contracts negotiated in accordance with procurement regulations:

(1) For contracts entered into prior to March 22, 1983, nonqualified pension costs accrued in accordance with CAS 412 and allocated to government contracts are allowable. This is in accordance with the decision in U.S. v. The Boeing Co., 802 F. 2nd 1390 (Fed. Cir. 1986).

(2) For contracts entered into after March 21, 1983 but before March 28, 1989, allowable nonqualified pension costs accrued in accordance with CAS 412 and allocated to government contracts are limited to the amount paid in the year the costs are assigned. This limitation is in accordance with the FAR 31.205-6(j)(5) requirements during this time frame.

(3) For contracts entered into after March 27, 1989, allowable nonqualified pension costs are limited to the amount computed in accordance with CAS 412 and 413. Funding is not required for allowability. This is in accordance with changes to FAR 31.205-6 effective March 28, 1989.

(4) The CAS 412 and 413 revisions that were effective March 30, 1995 apply as follows: The revised provisions shall be followed by each contractor on or after the start of its next cost accounting period beginning after the receipt of a contract or subcontract that is awarded on or after March 30, 1995 and is subject to full CAS coverage. Contractors with prior CAS-covered contracts with full coverage are to continue to follow the prior versions of CAS 412 and 413 until the revised standards become applicable following receipt of a contract or subcontract awarded on or after March 30, 1995 subject to full CAS coverage.

(5) For contracts subject to the revised CAS 412 and CAS 413, the costs of nonqualified defined benefit pension plans must be measured and assigned in accordance with the requirements specified in the revised standards. The costs of nonqualified pension plans must be accrued in the same manner as qualified plans under certain specific conditions (see CAS 412.50(c)(3)). If these conditions are not met, the nonqualified pension plan must use the pay-as-you-go cost method. For nonqualified pension plans that do not use the pay-as-you-go cost method, funding at the tax rate complement (i.e., 100% - tax rate %) is required by the revised CAS 412 as a condition for allocation of pension accruals to cost objectives

(See 8-412.4). For nonqualified plans using the pay-as-you-go cost method, pension costs assigned to a cost accounting period are allocable in the period assigned.

c. Reversion Credits Arising From Cancellation of Non-vested Benefits (see also 6-608.2d.(5)).

(1) When an employee withdraws from a pension plan or terminates his or her employment for reasons other than retirement or death, employer contributions made on his or her behalf, plus interest, to which no vested rights attach, serve to reduce the contractor's required future contributions. These are referred to as "reversion credits" (or in some cases "withdrawal gains"). While other credits or gains come within the scope of a reversion credit, the term as used in this paragraph relates to reversion credits arising from separation of employees who have not acquired vested rights. Reversion credits require particular attention because of the long term nature of pension plans and the possibility that completion or termination of government work will cause a serious cutback in a contractor's labor force. Since the contractor's annual contribution to a pension plan is net of that portion of any reversion credits used in determining the amount of the contribution, government contracts ordinarily would share in such credits to the extent that the net contribution for the year is included in the indirect cost pools and allocated to government contracts.

(2) Where the plan is funded through a contract with an insurance company, there is normally no advance consideration given to reversion credits. The necessary adjustment is normally applied as a reduction of the contractor's contribution to the insurance company for the then current taxable year or the next succeeding taxable year (or years in order of time if the aggregate amount of credit exceeds the premium cost otherwise due for the next succeeding taxable year). Reversion credits are usually quite readily ascertained under the insured type of funding arrangement.

(3) Where the plan is of the self-insured trustee type, the annual reversion credits normally reduce the employer's unfunded liability, and are therefore spread over later years (often the expected future service of members) and are only partially accounted for in any one subsequent year. Under most trustee type plans, isolated determination of the value of reversion credits is difficult to accomplish with any degree of accuracy.

(4) Ordinarily it will not be necessary to adjust for reversion credits arising from normal turnover of employees except to consider such reversion credits in calculating the contractor's net annual contributions. However, adjustment should be made if failure to do so would result in serious inequities to either the contractor or the government.

(5) Substantial reversion credits may occur at a time when government work has decreased to a point where it will not share the credits in the proportion that it absorbed the costs of pension contributions from which they are generated.

(6) One method for protecting the government's interest in abnormal reversion credits is the use of a "recapture" method whereby the contractor and the government enter into an agreement to negotiate a refund to the government, if and when appropriate.

(7) The contracting officer has the responsibility for sponsoring the negotiation of all recapture agreements on pension costs under DoD contracts. Accordingly, where a recapture agreement is required for the protection of the government's interests in future reversion credits, a copy of the pension plan together with an advisory report containing comments and recommendations shall be submitted to the contracting officer.

d. Funding Requirements

(1) When contributions are paid by a contractor to pension, profit sharing and employee stock ownership (ESOP) plans less frequently than quarterly, FAR 52.232-16 (progress payment clause) and FAR 52.216-7/8 (allowable cost, fee, and payment clause) provide that the accrued costs shall be excluded from indirect costs for payment purposes until such costs are paid.

(2) For contracts subject to one of the payment clauses cited in (1) above, contractors are permitted either to fund pension plans in total or to fund only those pension costs allocable to contracts containing the payment clause. Partial fund-

ing and delayed funding result in loss of earnings on trust fund assets and therefore result in increased future contributions and increased contract costs. Such increased costs are unallowable per FAR 31.205-6(j)(3)(iii), which states that "Increased pension costs caused by delay in funding beyond 30 days after each quarter of the year to which they are assignable, are unallowable." Contractors' actuarial rates and methods used in calculating normal and past service costs should be used to compute such unallowable pension cost contributions.

(3) Loss of earnings may impact future years' pension costs, and the unallowable cost should therefore be assigned to the years affected. Unallowable pension cost assigned to future years should be compounded with interest and actuarially amortized over the appropriate future years. As an alternative, however, if mutually agreeable, the unallowable pension cost can be assigned to the current year at the present value. This latter approach may, in fact, be preferable because there would then be no need for any follow-up action related to future adjustments.

(4) Form 5500, Report of Employee Benefit Plan, is required by the IRS to be submitted annually. This form identifies the actuarial assumptions used to determine pension costs and may be used to determine whether actual funding complies with FAR requirements. If the form discloses that late funding occurred, questioned cost (lost earnings, including the compounding effect on future years) should be computed using the actuarially assumed interest rate used by the contractor in computing pension costs.

e. Actuarial Assumptions. The funding required for a defined benefit pension plan is a function of the actuarial cost method and assumptions used. These assumptions typically involve rates of interest, mortality, disability, salary increases, and other factors affecting the value of pension assets and liabilities. In evaluating the validity of the assumptions, the auditor should determine that the assumptions are reasonable individually (revised CAS, effective March 30, 1995) or in the aggregate (pre - March 30, 1995 provision.).

f. Adjustment of Pension Costs.

(1) CAS 413.50(c)(12), FAR 15.408(g), and FAR 52.215-15 provide for an adjustment of pension cost when a segment is closed, a pension plan terminates, or benefits are curtailed. A segment closing occurs when a segment (1) is sold or ownership is otherwise transferred, (2) discontinues operations, or (3) discontinues doing or actively seeking government business under contracts subject to these provisions. The adjustment is computed as the difference between the actuarial accrued liability and the market value of the assets for the segment. Refer to 8-413.3 for additional guidance.

(2) When an adjustment is required, the contractor should be requested to provide a copy of the segment closing analysis mandated by CAS and FAR. The auditor should request the ACO to initiate a special CIPR to audit the contractor data for compliance with CAS 413 and/or FAR 52.215-15. If the contractor does not provide the analysis, a noncompliance audit report should be issued and the DLA pension specialist should be requested to estimate the magnitude of the adjustment.

7-606 Advance Agreements for Pension Plan Costs

7-606.1 Contract Risk Associated with Potentially Overfunded Pension Plans

a. For government contracting purposes, a pension plan is overfunded if the value of the plan's assets is greater than the actuarial liability plus normal cost for the current period, measured by the plan's actuarial cost method. This definition is the same as the definition used by the IRS prior to the signing into law on December 22, 1987 of the Omnibus Budget Reconciliation Act of 1987. The new law (P.L. 100-203) made a significant change to the way a contractor measures the full funding limitation for making contributions to its defined benefit pension plans under IRC regulations.

b. A pension plan is fully funded under P.L. 100-203 when the value of plan assets equals or exceeds the lesser of (1) 150 percent of current liability or (2) the actuarial liability under the plan. This method of

computing the full funding limitation is effective for years beginning after December 31, 1987. Prior to the new law, a pension plan was fully funded in accordance with the Internal Revenue Code (26 U.S.C. 412(c)) when the value of plan assets equaled or exceeded the actuarial liability plus normal cost for the current period under the plan.

c. Pension expense should be accrued only when there is a valid pension liability. A valid liability exists for pension costs when a plan's actuarial liability plus normal cost for the current period exceeds the plan asset values when evaluated under an acceptable actuarial cost method. Accordingly, a contractor has incurred a valid liability if it has not reached the full funding limitation under the old law. This liability should be assigned to the current cost accounting period even if it exceeds the full funding limitation under the new law. However, if there is no valid liability (asset values exceed the actuarial liability), there should be no pension costs assigned to the current period nor should costs be questioned in future periods for lost interest related to pension costs computed in excess of this full funding.

d. P.L. 100-203 may pose a problem for some government contractors if the pension costs computed in accordance with the pre - March 30, 1995 CAS 412 exceed the full funding limitation under this law. Under the pre - March 30, 1995 CAS 412, valid pension costs assigned to an accounting period cannot be reassigned to any other accounting period. In addition, costs assigned to an accounting period and not funded by the time set for filing a Federal tax return will not be allowable in accordance with FAR 31.205-6(j)(2)(i). To mitigate this conflict, on April 8, 1991 the new CASB authorized Federal procuring agencies to waive the cost assignment provisions of the pre - March 30, 1995 CAS 412.40(c), on a case-by-case basis (see 8-412.3).

e. Contributions made to a fully funded plan are subject to a 10 percent excise tax in accordance with the Tax Reform Act of 1986. This 10 percent excise tax is expressly unallowable for government contracting purposes in accordance with FAR 31.205-41(b)(6). This section of the FAR specifically disallows all excise taxes found at subtitle D, chapter 43 of the Internal Revenue Code of 1986, which includes excise taxes imposed in connection with pension plans, welfare plans, deferred compensation plans or similar types of plans.

f. An evaluation of current billing and bidding indirect expense rates should be made to determine whether or not forecasted pension expenses are valid. If a contractor plans to limit contributions to its pension plan based on the full funding limitation in P.L. 100-203 and the current or forecasted indirect expense rates include an amount for pension expense based on the old full funding limitation, pension costs may be overstated. If this is the case, and there is a material impact, a recommendation should be made to the cognizant contracting officer to withdraw the rates.

g. The auditor must keep in mind that a pension plan can be overfunded on a termination basis and yet be underfunded on an accrual (ongoing) basis. A pension plan is overfunded on a termination basis when the value of the plan's assets exceed the accrued liability computed in accordance with the plan benefit formula at a specific point in time. A pension plan is overfunded on an accrual basis when the value of the plan's assets exceed the actuarial liability computed using assumptions projected to some future date.

h. The actuarial liability can be computed by the entry age normal, unit credit, or projected unit credit funding method. The method used must be applied on a consistent basis. On a termination basis, the actuarial liability is computed as stipulated by the plan's provisions which govern a termination. The value of a plan's assets, for the purpose of determining a funding status, is the actuarial value computed in accordance with the requirements of the pre - March 30, 1995 CAS 413.

i. When a contractor's pension plan becomes fully funded, there is no valid liability to the pension fund and thus no cost is assignable to the accounting period. Full funding or the potential for full funding may create the opportunity for a contractor to receive windfall profits. For in-

stance, the pension plan may not be fully funded at the time contracts are priced or negotiated. If it becomes fully funded subsequent to negotiation of a fixed-price contract, the contractor could receive windfall profits.

j. The potential for windfall profits under these conditions created a need for advance agreements to protect the interests of the government. The government pays its allocable share of pension costs over the years and should receive its share of any credits, refunds, or reduced expenses if a plan becomes fully funded. If it is determined that a pension plan is overfunded or potentially overfunded on an accrual basis, then all pension costs both in forward pricing actions and in current contract billing rates should be questioned for the overfunded or potentially overfunded portion of the cost when there is no advance agreement (see 7-606.2).

7-606.2 Full Funding Limitation Advance Agreements

a. A full funding situation occurring subsequent to contract negotiations can result in overpricing to the government on fixed-price type contracts. Pension costs allocated to the contracts after full funding will be less than estimated and negotiated in the contract price. The full funding advance agreement serves to protect both contracting parties in the event a pension plan becomes fully funded during the course of contract performance. First, it allows the contractor to forecast pension expense even though its pension plan is fully funded or nearly fully funded. That way if the plan is not fully funded at the close of the accounting period, valid pension costs can be accepted. On the other hand, if the plan is fully funded at the close of the accounting period, the government will receive an equitable credit.

b. This credit does not necessarily have to be recovered through contract price adjustments. Adjustments to indirect rates may accomplish the same objective. Accordingly, auditors should discuss with the ACO alternative means of recovery which consider equity and administrative feasibility. However, the adjustment should result in substantially the same recovery from the same procuring activities as would be attained by contract-by-contract price adjustments.

c. The contract price adjustment for the full amount of the government's portion of the actuarial surplus shall either (1) be made in the year when the full funding limitation is reached or (2) be used to reduce current and future costs in accordance with an advance agreement. However, the parties may decide to immediately take the full reductions to indirect costs in the year of surplus if the contract mix would yield a reduction in costs on government contracts that equates to the government's fair share of the surplus. This approach eliminates the need to keep records of the government's portion of the actuarial surplus and could effect reductions in contract prices that may be in excess of the pension costs for that year.

d. If a contractor refuses to enter into a full funding advance agreement, and its plan is fully funded or there is a potential for the plan to become fully funded on an ongoing or accrual basis, then all pension costs both in forward pricing actions and in current contract billing rates should be questioned for the fully funded or potentially fully funded portion of the cost.

7-606.3 Advance Agreement for Transfers of Pension Fund Assets to Other Post-retirement Benefit Funds

a. FAR 31.205-6(j)(3) was revised effective September 23, 1991 to require an advance agreement regarding the withdrawal of pension fund assets which are to be transferred to another post-retirement benefit (PRB) fund. The advance agreement is to ensure that the increased pension costs to the government in all future periods is offset by a corresponding reduction or avoidance of future PRB costs to the government, as a result of the pension fund transfers.

b. Transfers made without an advance agreement will be treated as a withdrawal of pension funds subject to FAR 31.205-6(j)(4).

7-607 Accounting for Pension Costs in Accordance with Financial Accounting Standards Board (FASB) Statement No. 87

7-607.1 General

Starting in 1987, companies were required to implement the provisions in FASB Statement No. 87 for financial and reporting purposes. The statement was developed using (1) the concept of conservative accounting for the components of pension cost, (2) realistic statistics on companies' pension plan current obligations, and (3) the reporting of company financial pension obligations on the balance sheet. The mechanics and formula for the calculation of pension cost under the statement are different from those now permitted for contract costing purposes under CAS 412 and 413. Accordingly, just because a plan is in compliance with Statement No. 87 does not mean that it is in compliance with CAS 412 and 413.

7-607.2 Actuarial Cost Methods

a. Statement No. 87 only permits the use of either the unit credit actuarial cost method (used for fixed-benefit plans) or the projected unit credit actuarial cost method (used for percent of final pay plans). The spread gain method is no longer permitted for either financial or government cost accounting.

b. In addition to the unit credit and the projected unit credit actuarial cost methods, CAS 412.50(b)(1) allows the contractor to use the entry age normal actuarial cost method. This additional actuarial cost method may be used because it identifies separately normal costs, any unfunded actuarial liability, and periodic determinations of actuarial gains and losses.

7-608 Accounting for Early Retirement Incentive Payments

a. Early retirement incentive payments are payments offered to employees to induce them to terminate their employment and receive immediate pension benefits. The payment is usually a lump-sum amount based on a formula which takes into consideration the employee's current salary and years of service.

b. Early retirement incentive plans which are not paid for life or offer payments for life do not represent life income settlements and therefore do not qualify as pension plans. However, FAR 31.205-6(j)(7) requires that in order to be allowable, the cost of early retirement incentive plans be accounted for and allocated in accordance with the contractor's system of accounting for pension costs. These costs should be treated the same as pay-as-you-go supplemental pension plans. CAS 412. 50(b)(4) provides that the cost of benefits under a pay-as-you-go pension plan shall be measured in the same manner as are the costs of defined benefit plans whose benefits are provided through a funding agency.

c. Early retirement incentive payments are generally made to participants over a period of time shorter than the amortization period required by FAR. However, for cost assignment, incentive payments must be treated as increases in pension benefits that result from unfunded past service liabilities and be amortized over the amortization period stated in CAS 412. 50(a)(1)(iii). The amount of increased past service liability from the incentive award is the net present value of the allowable portion of the incentive at the payment date (see 7-2107.1). Under pension accounting concepts, amounts funded or costed in future periods for prior years' unfunded liabilities contain interest in an amount actuarially determined.

7-609 Costs of Post-retirement Benefits (PRB) Other Than Pensions

7-609.1 Definition and Regulation

Post-retirement benefit (PRB) costs are defined and the criteria for allowability are set forth in FAR 31.205-6(o). In general, the costs are for benefits provided for specified purposes to contractor employees after retirement. The same benefits are the subject of FASB Statement 106.

7-609.2 Allowability Determination

a. The costs must be reasonable and must be incurred according to a plan set by law, employer-employee agreement, or an established policy of the contractor.

b. The costs will be measured and assigned to accounting periods using one of three methods: Cash Basis, Terminal Funding, or Accrual Basis.

c. Cash Basis costs are recognized when actually paid to provide benefits to retirees for the current period. These costs have actually been incurred, have been paid out, and are for only the current period's benefits. The costs may include the amortization of prepaid costs over the applicable amortization period.

d. Terminal Funding occurs when the entire cost of a retiree's post-retirement benefit is accrued and funded upon the termination of the employee. The funding is accomplished by purchase of a paid-up benefit or by deposit of an amount equal to the present value of the projected benefit in a trusteed fund. Both CAS 416.50(a)(1)(v)(C) and the FAR require the amount terminally funded to be amortized over 15 years for government costing. If a non-CAS covered contractor proposes this accounting and funding method, it should be evaluated for allowability as a form of the Cash Basis method; i.e., amortization of prepaid costs over an appropriate period.

e. Accrual Basis recognizes costs in accordance with FASB Statement 106. Compliance with FAS 106 and FAR 31.205-6(o) should also be considered as satisfying CAS 416 provisions which require that pre-funded retiree insurance programs "apportion the cost of the insurance coverage fairly over the working lives of active employees in a plan." FAR 31.205-6(o) places the following requirements on accrued PRB costs:

(1) Costs must be funded by the time set for filing the Federal income tax for the period.

(2) Increased costs resulting from funding delays beyond 30 days after the end of each contractor fiscal quarter are unallowable.

(3) The allowable amount of past service cost is limited to the amount calculated using the FAS 106 amortization method provided for "transition liability." The past service costs of PRB plans are the previously unrecognized costs which would have been recognized during prior years if the contractor had been accruing the PRB as earned over the working lives of the employees. "Transition liability" is a term used in FAS 106 which, for contract costing purposes, is substantially the same as past service costs. (FAS 106 also allows an immediate recognition method for transition liabilities which the FAR does not allow for government costing purposes.)

f. Funding of PRB costs under either the Terminal Funding or the Accrual Basis methods must be made by payment to an insurer or trustee to establish and maintain a fund or reserve for the sole purpose of providing PRB.

g. The government is entitled to an equitable share of any PRB funds which revert or inure to the contractor.

7-700 Section 7 --- Patent Costs and Royalty Costs

7-701 Introduction

This section provides the general audit guidance in auditing patent and royalty costs under FAR, DoD FAR Supplement, and 37 CFR Chapter IV, Part 401.

7-702 Patent Costs

7-702.1 General Considerations

A patent for an invention is the government's grant to an inventor of the right to exclude others from making, using, or selling the invention for a 17-year period. Activities involved in getting a patent include searching through prior patents to determine whether the invention, or something similar to it, has already been patented; preparation of an application for the patent to the Patent and Trademark Office of the Department of Commerce; and prosecution (follow-up) of the application until the patent is granted or rejected.

a. FAR Part 27 and DoD FAR Supplement Part 227 establish DoD's policy with respect to patents. Contracting officers implement the policy by inserting one of the clauses set forth in FAR 27.303 into research and development contracts. Each of the clauses provides that the government will obtain title to, or royalty-free use of, "subject inventions."

b. A "subject invention" (which is defined in the clauses) is one that is conceived or first actually reduced to practice under the contract.

c. FAR 31.205-47(f)(6) states that the cost of patent infringement litigation is unallowable unless otherwise provided for in the contract.

d. FAR 31.205-30 governs the allowability of the costs of obtaining patents. Costs incurred on patents to which the government obtains title or royalty-free license are allowable to the extent that they are incurred as requirements of a government contract (see FAR 31.205-30(a)). Also allowable are general counseling services relating to patent matters, such as advice on patent laws and regulations (see FAR 31.205-30(b)).

e. Other than those for general counseling services, patent costs not required by the contract are unallowable (see FAR 31.205-30(c)). Under CAS 405.40(a) such costs, including costs mutually agreed to be unallowable directly associated costs, shall be identified and excluded from billings, claims, and proposals.

f. Frequently, unallowable patent costs are not segregated in the contractor's accounting system. In these cases, CAS 405.50(a) and (b) permit the use of less formal cost accounting techniques. These less formal techniques may use backup data and working papers to establish adequate identification of all costs including unallowable cost and should be maintained for audit verification.)

7-702.2 Patent Costs/Income Related to Small Business and Nonprofit Organizations

a. The Department of Commerce Patents, Trademarks, Copyrights, 37 CFR Chapter IV, Part 401 provides policies, procedures, and guidelines on inventions made by small business firms and nonprofit organizations, including universities under funding agreements with Federal agencies.

b. After payment of expenses (including payments to inventors) incidental to the administration of subject inventions, any royalties and/or income earned by the contractor (nonprofit organization) from inventions will be used to support scientific research or education in accordance with 37 CFR Chapter IV, Part 401.

7-703 Royalty Costs

7-703.1 Royalty Charges

Contractors are required to submit with their proposals under any negotiated contract in excess of $550,000 (see FAR 15.403-4(a)(1)) detailed information on all royalty costs of more than $1,500 which are included in the proposal (see FAR 15.408, Table 15-2 II.E.). The contracting officer is responsible for determining that royalties in excess of $1,500

charged directly or indirectly to government contracts have been reported under the provisions of FAR 27.204-1 to the appropriate government office. This allows the government to determine whether or not the royalty charges are excessive, improper, or inconsistent with any license or right to an invention which the government may have acquired under government-sponsored research. In accordance with these determinations, the auditor should assure that improper direct or indirect charges for royalties are disapproved when claimed under cost-type contracts or questioned in advisory reports submitted for negotiation purposes.

7-703.2 Unpaid Royalties

a. DCAA has found cases where contractors included royalty charges in the costs used to negotiate contract prices but subsequently did not have to pay them in whole or in part. Such royalty charges are considered recoverable when (1) a contractor finds that it has been released from obligations to pay royalties (that is, when such release is the result of government antitrust actions against the patent holders) or (2) the royalty estimates are overstated or are based on items that are not subject to royalties (see FAR 27.206-1).

b. In some instances contracts contain recapture provisions to become effective in the event actual royalty payments are less than those estimated and included in the negotiated prices. Other contracts contain no specific provisions for the recovery of unpaid royalties. FAR 27.206-1 provides guidance for determining when royalty escrow or recapture provisions are appropriate for inclusion in a contract.

c. DCAA auditors will insure that audit programs provide for periodic review of a contractor's accrued royalty accounts to determine the nature and validity of unpaid royalties. DCAA auditors will take the following minimum steps:

(1) Ascertain that contracts are complying with contract provisions that require the submission of reports of royalties paid or payable under the contract.

(2) Examine royalty reports submitted to contracting activities, to confirm the accuracy of the royalties reported as paid, or due to be paid, and the adequacy and timeliness of refunds made under contracts containing either escrow or recapture provisions.

(3) Determine the propriety of retention by the contractor of unpaid royalties if the terms of the contracts or the equities of the situation indicate that the government is entitled to refunds or credits for any part of such unpaid royalties.

7-703.3 Royalty Income---Small Business and Nonprofit Organizations

37 CFR Chapter IV, Part 401 provides policies, procedures, and guidelines with respect to inventions made by small business firms and nonprofit organizations including universities, under funding agreements with Federal agencies. Any royalties and or income earned by the contractor (nonprofit organization) from inventions will be used to support scientific research or education in accordance with 37 CFR Chapter IV, Part 401.

7-800 Section 8 --- Labor Settlement and Strike Period Costs

7-801 Introduction

This section provides audit guidance in determining acceptable labor settlement costs and public policy as to the acceptability of strike period costs.

7-802 Labor Settlement Costs

Labor settlement costs (awards) can arise from judicial orders, negotiated agreements, arbitration, or an order from a Federal agency or board. The awards generally involve a violation in one of three areas: (1) Equal Employment Opportunity (EEO) laws, (2) union agreements, and (3) Federal labor laws.

7-802.1 Types of Awards

a. The award can be for compensatory damages, punitive damages, or underpayment for work performed, or it can involve fines and penalties. A settlement may include one or more of these type costs. FAR 31.205-15, Fines and Penalties, provides that any fine or penalty assessed would be expressly unallowable except when incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer.

b. FAR 31.205-6(k) defines deferred compensation as an award given by an employer to compensate an employee in a future cost accounting period or periods for services rendered in one or more cost accounting periods before the date of receipt of compensation by the employee. Subject to FAR 31.205-6(a), deferred awards are allowable when they are based on current or future services. However, awards made in periods subsequent to the period when the work being remunerated was performed are not allowable.

7-802.2 Case by Case Determination

a. The allowability of settlement costs associated with other areas should be determined on a case-by-case basis after considering the surrounding circumstances; i.e., the auditor should look behind the settlement and consider the causes. If the dispute resulted from actions that would be taken by a prudent businessman (FAR 31.201-3), the costs would be allowable. However, if the dispute was occasioned by actions which appear unreasonable or were found by the agency or board ruling on the dispute to be caused by unlawful, negligent, or other malicious conduct, the costs would be unallowable and, should be questioned.

b. Allocability of these costs must be reviewed (see FAR 31.201-4). For CAS-covered contracts, the provisions of CAS 406.40(b) regarding treatment of prior period adjustments must be considered in determining the treatment of allowable backpay awards. As with other items of cost, if the amount of the award is not material, it can be treated as an indirect cost of the period incurred.

(1) Where the violation which gave rise to the award can be identified to a specific contract(s), the entire award should be charged to that contract(s). The cost would not be allocable to any other contract and should not be included in an indirect cost pool. However, when the contract(s) which gave rise to the award is closed, consideration should be given to including the award in an indirect cost pool provided that the amount charged to government contracts is no greater than that which would have been charged to the government if the contract(s) was open.

(2) Other points to be considered are: (a) when the award is for work performed by direct employees, it may impact not only direct costs, but also indirect costs due to the increase in the allocation base, (b) when a negotiated union contract calls for a retroactive increase, the additional costs should be charged to the same final cost objectives that the actual work performed was charged.

(3) Very often there is a substantial time between when a suit is filed and payment of the award. An inequitable allocation to government flexibly priced contracts would result where indirect employees are involved and there has been a substantial change in the flexible contract mix in the interim period. For example, if government

flexibly priced contracts represented 10 percent of a firm's business at the time the suit was filed, the government should not be expected to pay more than 10 percent of the ultimate award.

7-803 Strike Period Costs

FAR does not provide specific guidance with respect to the allowability of costs during strike periods. Underlying this matter are considerations of public policy, and the difficulties that would be encountered in any attempt to provide adequate coverage for the differing situations frequently precipitated by strikes. As a result, the allowability of costs during strike periods shall be considered on an individual case basis.

a. FAR 22.101-1(b) states that "Agencies shall remain impartial concerning any dispute between labor and contractor management and not undertake the conciliation, mediation, or arbitration of a labor dispute." FAR 22.101-2(b) provides that in the event labor disputes give rise to work stoppage, "Contracting officers shall impress upon contractors that each contractor shall be held accountable for reasonably avoidable delays." "All costs incurred during strikes shall be carefully examined to ensure recognition of only those costs necessary for performing the contract in accordance with the government's essential interest." (see FAR 22.101-2(c)).

b. Strike period indirect costs included in contractors' cost representations should be identified and segregated into the following categories to facilitate a determination as to allowability, allocability and reasonableness of the costs:

(1) Costs directly attributable to the strike, which would not have been incurred otherwise, such as extra security guards, special legal expense, arbitration costs, etc.

(2) Costs which were abnormally higher during the strike period, such as recruitment, training of new employees, etc.

(3) Audit determination of indirect costs of a continuing nature, such as cost of normal plant maintenance, depreciation, rent, other fixed charges, supervisory and administrative personnel, etc., will depend on reasonableness, within the framework of existing circumstances with respect to the strike; the extent to which subsequent production makeup operations were undertaken to maintain production schedule; the action taken by the contractor to minimize costs during the period; and such other factors as have a bearing on the expeditious settlement of the dispute.

c. Allocating indirect costs during a strike period to a contractor's commercial or defense work may consider the total period covered by the labor agreement signed at the conclusion of the strike as the basis for allocating strike period costs. Where, for example, a 3-year labor agreement is reached, a proration or amortization of strike period costs over production during the next three years may be appropriate.

7-900 Section 9 --- Employee Training and Educational Costs

7-901 Introduction

This section pertains to the employee training and educational cost principle in FAR 31.205-44. The allowability of other types of training and educational costs will be determined on a case-by-case basis in accordance with FAR 31.204(c).

7-902 Differentiation of Types of Training Programs

FAR 31.205-44 treats separately the costs of (1) vocational training at a non-college level, including on-the-job, classroom, and apprenticeship training, designed to increase the vocational effectiveness of employees; (2) part-time college education at undergraduate and postgraduate levels; (3) full-time education at post graduate level; and (4) specialized programs of executive and managerial training, such as OMB courses, industry seminars, etc., for bona fide employees of the contractor. There are important differences among these four kinds of training and education in terms of objectives and specific limitations on allowable costs. It should be noted, however, that the cost principle is not designed to limit the allowability of reasonable costs of orienting an employee in the various facets of a job to which he or she is newly assigned.

7-903 General Audit Considerations

a. Training programs vary from contractor to contractor, depending on the relative need for training, training objectives, the size, stability and composition of the work force and other such factors. Where training is a continuous rather than a spasmodic activity, involves a substantial number of employees, and results in allocation of significant amounts of costs to government work, the contractor should be required to maintain a well-defined training program based on formal policies and procedures. The policies and procedures should be compatible with the accounting system used to record and distribute costs to cost objectives.

b. Initial audit effort should be directed towards evaluating the contractor's training policies and practices, as well as the related cost accounting procedures. Where the training program is extensive and government work absorbs a significant portion of the total costs, technical assistance should be obtained through the Administrative Contracting Officer if it may be helpful in evaluating the scope and effectiveness of the program. Costs of the program should be recorded in a manner to facilitate determination of the amount allowable in accordance with the cost principle, supplemented by the provisions of the advance agreement where applicable. A training manual is maintained by most major contractors. This manual should prove useful to the auditor in reviewing the company's criteria for determining employee eligibility and need for specific training courses or activities.

c. Each assignment should evidence that the employee is both eligible and requires the education or training to which he or she has been assigned. The contractor should also be expected to monitor the program to assure regular attendance and adequate course performance by the personnel enrolled. The program should include procedures for evaluating the suitability and sufficiency of each course of study or activity. Systematic post-training observation by the contractor of trainees' progress on the job would assist in achieving this objective.

d. Costs of training materials and textbooks are allowable at each of the training levels covered in FAR 31.205-44. Such items are considered to represent those prescribed for use in each course of study or training activity.

e. The determination as to whether a course of study is of college level or non-college level, or whether it is part-time or full-time, must be made for the purpose of determining which provision ((b), (c), (d), or (e)) of FAR 31.205-44 is applicable under any set of conditions. "College level" is not governed by whether a college credit is granted or available upon successful completion of the course of study; course content and prerequisite

requirements are controlling. As between "part-time" and "full-time " college level education, two conditions must be satisfied to support a determination that the education is "full-time." First, the period of study must be equivalent to that of a semester or other recognized period of instruction into which the academic year of an education institution is normally divided. Second, the trainee or student must be in full-time attendance (as that term is defined by the college involved), during otherwise regular working hours, for the duration of the course of study. If either of these conditions is not met, then the college level education should be considered "part-time" under FAR 31.205-44(c).

f. Auditors should evaluate contractors' training policies and practices to insure that contractors who provide full reimbursement of tuition have a policy that prevents recipients from receiving reimbursement from both contractors and other outside sources. (For example, even though college tuition reimbursement for veterans would be allowable under FAR 31.205-44, it is not reasonable for a veteran to receive reimbursement for training cost from the Veterans Administration in addition to that granted by an employer. Therefore, that portion of college tuition reimbursement for veterans (excluding the veterans contributions) that would amount to a reimbursement duplication should be questioned based on reasonableness (see FAR 31.201-3).

g. Training costs incurred by contractors to help make persons hired under the President's Welfare-to-Work Initiative productive employees, will be considered allowable costs in accordance with Defense Secretary William Cohen's April 5, 1997 memorandum. However, when evaluating the allowability of training costs and wages of employees hired under the Welfare-to-Work Initiative, auditors should determine whether the contractor is receiving reimbursement from the state or local government for these employees under the Job Training Partnership Act. Contractors receiving such reimbursements as part of the Job Training Act should not receive duplicative reimbursement under government contracts, and therefore an appropriate credit should be given to the government (see 7-2113).

7-904 Special Provisions of FAR 31.205-44

a. By provision of FAR 31.205-44(c)(4), straight time compensation of an employee is allowable up to a maximum of 156 hours per year for time spent in part-time college level education during working hours. However, allowability is restricted to cases where circumstances do not permit the operation of classes or attendance at classes after regular working hours. Where the incidence of these costs is high, the auditor should assure himself or herself that circumstances do not in fact permit holding classes or attending classes after regular working hours.

b. FAR 31.205-44(d) establishes the cost principle for full-time education at a postgraduate (but not undergraduate) college level. Costs are allowable only when the course or degree pursued is related to the field in which the employee is working or may reasonably be expected to work and are limited for each employee to a total period not to exceed two school years or the length of the degree program, whichever is less. In instances where costs for a period in excess of two school years are claimed, and the contractor has not obtained an advance agreement pursuant to FAR 31.205-44(h), such costs should be questioned. Allowable costs consist of tuition, fees, training materials, and textbooks; but not subsistence, salary, or any other emoluments.

c. The auditor should determine that the training and education function does not discriminate against government business or result in undue charges to government contracts. This would occur, if, for example, a company regularly hired new employees in its government-oriented divisions, charged their training costs thereto, and then transferred the trained employees to their commercial oriented divisions. Training and educational costs should properly be charged or allocated on a benefit basis. Such benefit would ordinarily be considered to accrue to the organizational segment(s) or profit center(s) of the company in which the

personnel are expected to function (for a reasonable period of time) as a consequence of the training or education provided to them.

d. During their apprenticeship or on-the-job training period, employees may be partially productive. If the degree of such productivity is significant and it can be conveniently and reasonably determined, the amount of such productive work should be charged in the same manner as comparable work performed by other employees. In this case, only the balance between total compensation and the amounts so charged would represent training cost. Where it is not practicable to account for apprenticeship or on-the-job training, total period costs may be chargeable to the appropriate direct or indirect cost classifications for the work areas involved. (See also 6-204 regarding charges to time and material contracts.)

e. Contractors receiving reimbursement for the costs of certain employees' training under the Job Training Partnership Act should not receive duplicate reimbursement under government contracts. (See 7-2113 for additional guidance.)

f. FAR 31.205-44(h) states that training and educational costs of the type covered in FAR 31.205-44(c) and (d), exceeding those otherwise allowable, may be allowed to the extent negotiated in an advance agreement under FAR 31.109. However, advance agreements cannot make FAR unallowable costs allowable. To be considered for an advance agreement, the contractor must demonstrate that such costs are consistently incurred pursuant to an established managerial, engineering, or scientific training and educational program, and that the course or degree pursued is related to the field in which a bona fide employee is now working or may reasonably be expected to work. To avoid unnecessary audit work in determining allowable costs, the auditor should review, beforehand, the details of existing or pending advance agreements based on the contractor's demonstration as prescribed in FAR 31.205-44(h).

7-1000 Section 10 --- Employee Travel Costs and Relocation Costs

7-1001 Introduction

a. This section covers basic guidance, including the applicable FAR provisions, in reviewing employee travel costs and travel costs related to contractor -owned, -leased, or -chartered aircraft.

b. Also, presented in this section is audit guidance and applicable FAR provisions in reviewing employee relocation costs.

7-1002 Employee Travel Costs

7-1002.1 General Considerations

Audits of travel costs (see FAR 31.205-46) should include appropriate examination of the contractor's travel policies and procedures as well as the selective review of individual trips made by contractor personnel. Coverage of this area should thus include a determination that the contractor's travel authorization procedures provide for documented justification and approval of the official necessity of each trip, its duration, and the number of travelers involved. The contractor's procedures should provide for advance planning of travel to assure that

(1) wherever feasible and economically practical, required visits to locations in the same geographical area are combined into a single trip,

(2) maximum use is made of the lowest customary standard, coach, or equivalent airfare accommodations available during normal business hours, and

(3) coordination between organizational elements is effected to minimize the number of trips to the same location. Individual trips should be reviewed to determine if

(a) the contractor is complying with its travel policies and procedures,

(b) the trip is for an allowable purpose, and

(c) the incurred travel costs are documented and allowable in accordance with FAR 31.205-46. In addition, the auditor should review the contractor's accounting procedures to determine whether or not they provide adequate controls for segregating unallowable travel costs.

7-1002.2 Documentation Required

FAR 31.205-46(a)(7) states that costs are allowable only if the contractor maintains specific documentation to support claimed travel costs. The documentation requirements are similar to the long-standing requirements imposed by Section 274 of the Internal Revenue Code (IRC). For claimed costs to be allowable, the following information must be documented:

(1) date and place (city, town, or other similar designation) of the expenses,

(2) purpose of the trip; and

(3) name of person on trip and that person’s title or relationship to the contractor.

This information must be maintained in a book, diary, account book, or similar records. Documentation such as cancelled checks, credit card receipts, and hotel bills are to be maintained as corroboration for expenses, but without the diary or similar records, they may not be sufficient support for deductibility.

7-1002.3 Allowability of Per Diem Costs Under FAR 31.205-46

a. FAR 31.205-46(a) states that costs for lodging, meals, and incidental expenses may be based on (i) per diem, (ii) actual expenses, or (iii) a combination of a fixed amount and actual expenses. However, except for special or unusual situations, allowable costs are limited on a daily basis to the "maximum per diem" rates in effect at the time of travel set forth in the government travel regulations as follows:

(1) Federal Travel Regulations, for travel in the conterminous 48 United States. These rates are available on the GSA web site www.gsa.gov under Policy.

(2) Joint Travel Regulations, for travel in Alaska, Hawaii, the Commonwealth of Puerto Rico, and territories and possessions of the United States.

(3) Department of State Standardized Regulations, Section 925, Maximum Travel Per Diem Allowances for Foreign Areas, for travel to foreign countries.

b. Effective January 1, 1999, GSA significantly changed the methodology for calculating maximum per diem rates listed in the Federal Travel Regulations. Specifically, GSA removed lodging taxes from the stated lodging rate and instead allowed the payment of actual costs for lodging taxes as a miscellaneous expense. In addition, GSA removed laundry, cleaning, and pressing of clothing from incidental expenses and included them as reimbursable miscellaneous expenses (with a minimum of 4 consecutive nights lodging). However, these changes apply only to travel subject to the Federal Travel Regulations; in other words, travel within the Continental United States. These changes were not made for Alaska, Hawaii, Puerto Rico, and U.S. possessions covered by the DoD Joint Travel Regulations and foreign travel covered by the Department of State Standardized Regulation. Therefore, travel within and outside the Continental United States will be subject to different criteria for allowability for travel costs incurred on or after January 1, 1999.

c. In recognition of the administrative burden that might be placed on contractors due to the GSA methodology change described in b. above, the Director of Defense Procurement issued a class deviation for DoD contracts and subcontracts, allowing the contractor to choose to use either the FTR rates and definitions effective on December 31, 1998, or the current FTR rates and definitions. This DoD class deviation, dated December 23, 1998 was extended to September 16, 1999, July 24, 2000, and again on September 10, 2001. The deviation is effective until September 30, 2002 or until FAR 31.205-46(a)(2) is revised, whichever occurs first. On January 15, 1999, NASA issued a similar class deviation for NASA contractors. These class deviations do not permit contractors to choose between the per diem rates on a trip-by-trip basis. Rather, the contractor must choose either the 1998 definitions and rates OR the current definitions and rates for all travel.

d. FAR 31.205-46 does not incorporate the government travel regulations in their entirety. The requirements and provisions of the government travel regulations are to be applied to contractors only in the following three specific areas:

(1) Definitions of lodging, meals, and incidental expenses. Prior to the GSA change explained in c. above, incidental expenses included fees and tips to waiters and porters; laundry, cleaning and pressing of clothing; transportation between places of lodging or business and places where meals are taken, if suitable meals cannot be obtained at the TDY site; and mailing costs associated with filing travel vouchers and payment government-sponsored charge card billings. This definition continues to apply to all travel outside the continental United States. However, effective January 1, 1999, for travel subject to the Federal Travel Regulation (continental United States) incidental expenses do not include laundry, cleaning and pressing of clothing because these costs are now allowed as miscellaneous expenses.

(2) Maximum per diem rates. Maximum per diem rates are a combination of lodging plus meals and incidental expenses. The government travel regulations provide for two ceiling amounts: one for lodging and one for meals and incidental expenses. However, contractors are subject to only one ceiling, a total of lodging plus meals and incidental expenses.

(3) Special or unusual situations. The applicable travel regulations provide for special or unusual situations where reimbursement of a higher amount (e.g., up to 300 percent of the applicable maximum per diem rate for domestic travel) is authorized based on actual expenses incurred. Examples of such situations include when: (a) the employee must stay at a prearranged hotel where he or she attends a conference or training session; and (b) the travel is to an area where subsistence costs have escalated for short periods of time during special functions or events such as sports events, world fairs, or conventions. For costs in excess of the maximum per diem rates to be allowable, FAR 31.205.46(a)(3) requires a written justification for use of the higher amounts, signed by an officer (or designee) of the contractor. Addition-

ally, if the higher rate is used repetitively, the contractor must obtain advance approval from the contracting officer.

e. The contractor may adopt policies for reimbursing employees for travel expenses based on actual expenses, fixed amount, or a combination of actual expenses (e.g., for lodging) and a fixed amount (e.g., for meals and incidental expenses). In any event, allowable costs to government contracts may not exceed the maximum per diem rates specified in the government travel regulations. If a contractor's policy is to reimburse its employees a fixed amount (per diem) for subsistence within the prescribed maximum daily per diem rates, there is a presumption that the costs are reasonable and allowable and detailed receipts or other documentation are not required to support claims by employees. On the other hand, if a contractor's policy is to reimburse its employees actual expenses incurred, all unallowable costs (such as, alcoholic beverages and entertainment) must be separately identified and excluded from billings, claims, and proposals to the government in accordance with FAR 31.201-6 and CAS 405.

f. The maximum Federal per diem rates reflect allowance for lodging, meals, and incidentals for a 24-hour period. Use of those rates when travel does not require a full day or does not require lodging expense would be inconsistent with the rate structure. While the cost principle does not prescribe a specific reduction formula for contractor use to account for partial days, it does state that use of the maximum rates in such situations would generally be unreasonable. Contractors must provide for a reasonable reduction from the maximum rates when lodging, meals, or incidentals are not required.

7-1002.4 Use of Statistical Sampling to Segregate Unallowable Costs

a. When employee reimbursement for travel expense is based on actual costs incurred, FAR 31.201-6 and CAS 405 require contractors to demonstrate that all unallowable costs are separately accounted for and excluded from all billings, claims, and proposals to the government. The use of a statistical sampling analysis to segregate unallowable costs would not generally meet the requirements of the CAS and the FAR. CAS 405.50(a) and (b) and FAR 31.201-6(c) require contractors to establish and maintain sufficient detail and depth of records of identified unallowable costs so as to permit audit verification of the accounting treatment for the unallowable costs. The use of a projection or estimate of unallowable costs in lieu of specific identification of such costs, even though based on a valid statistical sampling analysis, normally would not be compliant with the requirements of CAS 405.50(a) and (b) and FAR 31.201-6(c).

b. In circumstances where costs involved are not material, CAS 405.50(c) provides that the government and the contractor may reach an agreement on an alternate method in lieu of specifically identifying unallowable costs. In evaluating the contractor's submission for the use of an alternate method of identifying unallowable costs, consider such factors as materiality of unallowable portions of per diem costs and additional administrative costs required to specifically identify such unallowable cost. Consider, for example, a situation such as a corporate home office of a contractor whose government work represents only a minimal portion of its total business. The requirement to specifically identify and segregate all unallowable per diem costs could cost significantly more than the cost of the unallowable items. If the contracting officer agrees that an alternate procedure would be advantageous to the government, the contractor may use statistical sampling or other appropriate methods to estimate the unallowable costs. If a circumstance warrants the use of statistical sampling analysis to estimate the unallowable travel costs, auditors must ensure that proper sampling techniques are used.

7-1002.5 Allowability of Airfare Costs

a. Allowable airfare costs are limited to the lowest customary standard, coach, or equivalent airfare offered during normal business hours, except for special circumstances set forth in FAR 31.205-46(d). Because airlines use many different fare codes to indicate the class of service, de-

termining the lowest fare class regularly offered during normal business hours may be difficult. However, an explanation of the fare codes may generally be obtained from the contractor's travel agency and/or the applicable airline.

b. A "business class" accommodation which is offered at a price slightly lower than the first-class fare does not meet the FAR criteria for reasonableness and allowability. Conversely, use of special discount, excursion, or night rates as a matter of common practice should not be required when use of such fares is impractical for business travel purposes, results in circuitous routing, or causes travel accommodations not reasonably adequate for the physical needs of the traveler.

c. Whenever the contractor is able to obtain special fares (Ultra Savers, Ultimate Super Savers, etc.) in lieu of full economy fares, the resulting cost savings should be reflected in any billing, claim, or proposal submitted by the contractor. Travel agencies often prepare and provide to their customers airline cost savings reports designed to attract and retain customers. In connection with forward pricing, the auditor should review any recent savings reports to make sure that the proposed airfare costs reflect appropriate savings. Alternatively, at contractor locations where travel costs are significant, the auditor should recommend that the contractor develop a decrement factor to be applied when basic cost estimates are based on full economy fares rather than achievable, lower special fares.

d. Increased competition among airlines has resulted in certain airline companies offering various promotional benefits including cash, merchandise, gifts, prizes, bonus flights, reduced-fare coupons, upgrade of service, membership in clubs, check-cashing privileges, and free vacations. Contractors are not required to collect airline promotional benefits from their employees. It is up to each contractor to establish its own policy addressing the treatment of these promotional benefits. However, if a contractor has a policy that results in its employees turning in the frequent flyer bonus credits for company use, then the auditor should ensure that the government receives its applicable share of any credits actually received by the contractor. In those instances where contractors have executed agreements with individual airlines for discounts and bonuses, auditors should determine that appropriate credits or cost reductions are being reflected in forward pricing and actual costs submissions, and that appropriate use of the agreement is being made.

7-1003 Travel Costs on Contractor Aircraft - Owned, Leased, or Chartered

7-1003.1 General Audit Considerations

a. FAR 31.205-46(e) sets forth principles and criteria for determining the allowability of costs incurred in the operation and maintenance of contractor-owned, -leased, or -chartered aircraft (collectively referred to as private aircraft).

b. As a general rule, travel costs via private aircraft in excess of the standard commercial airfare are unallowable. Exceptions to this general rule are described in 7-1003.2. The use of private aircraft generally results in higher costs than travel by commercial airlines or other modes of transportation.

7-1003.2 Conditions for Allowability of Contractor-Owned, -Leased, or -Chartered Aircraft

a. As a prerequisite to allowability, the contractor must maintain and make available to the government full documentation in support of the costs including the manifest/log for all flights (see 7-1003.6). If the contractor fails to maintain required documentation or refuses to provide such documentation, the auditor should disallow costs in excess of otherwise allowable standard commercial airfare.

b. Travel costs via private aircraft in excess of the standard commercial airfare are allowable in two situations: (1) when travel by such aircraft is specifically required by contract specification, term, or condition; or (2) when a higher amount is approved by the contracting officer.

c. All or part of excess costs incurred for operating private aircraft may be approved by the contracting officer: (1) when one or more of the conditions described in FAR 31.205-46(d) are present that would

justify costs in excess of the lowest standard commercial airfare, such as requiring circuitous routing, travel during unreasonable hours, or excessively prolonged travel; or (2) when an advance agreement has been executed.

7-1003.3 Use of Advance Agreements

a. When the contractor proposes an advance agreement with respect to the costs of company aircraft, the auditor should evaluate the contractor's proposal and provide audit findings and recommendations to assist the contracting officer in establishing the negotiation objective. The auditor should request technical assistance in areas such as the size, type, and number of aircraft; safety factors; and other technical requirements of aircraft.

b. In evaluating the contractor's proposal, the auditor should consider major financial and nonfinancial factors. Generally, the contractor must demonstrate that scheduled commercial airline service is not readily available at reasonable times to accommodate the company's air travel requirements. In addition, proximity of commercial airports to the contractor's location as compared to private air fields that are used, or are intended to be used, is also a factor in conjunction with any time savings of key personnel. Increased flexibility in scheduling flights may result in time savings and more effective use of personnel. However, the auditor should be mindful that a contractor in the normal course of conducting its business seldom needs corporate aircraft and that the convenience of corporate aircraft should not be a substitute for the economy of commercial flights. While there may be critical or emergency situations that cannot be effectively handled by commercial flights, such situations generally occur so infrequently that they do not justify the long-term use of corporate aircraft. It is the contractor's responsibility to justify and demonstrate that the need for corporate aircraft truly outweighs cost savings arising from the use of commercial airlines.

c. The ASBCA ruled (in the General Dynamics case no. 31359, 92-2, BCA 24922) that "time savings, productivity gains, or more effective use of personnel" can be used to demonstrate and justify the higher cost of private aircraft. It is the contractor's responsibility to provide the government a fully supported submission to demonstrate that these savings exceed the costs of using private aircraft as compared to using commercial airlines. The ASBCA also ruled that it is appropriate for the contractor to consider the value of executive time in the cost-benefit analysis. The ASBCA accepted the concept that the calculation of the value of the executive's time could include an estimate of the executive's value to the corporation in addition to the executive salary and fringe benefits. The ASBCA referred to the estimate of the executive's value to the corporation as a "multiplier." The use of a multiplier by the contractor should not be accepted solely as a result of the ASBCA case. The contractor must provide supporting data to justify any proposed multiplier. If the contractor does not justify the use of a multiplier, the related costs should be questioned.

d. The costs associated with private aircraft flights should be allocated to all passengers. The information listed in 7-1003.6 is required by the cost principle to determine if unallowable trips such as spousal travel have been identified and all allocable costs to the unallowable trips were excluded from reimbursement by the government. The auditor should recommend that the advance agreement state that unallowable passenger trips be allocated their fair share of costs and these costs should be excluded from requests for reimbursement by the government.

e. In situations where the contractor's proposal includes acquisition of an aircraft, either through purchase or capital lease, the auditor should carefully review the feasibility studies the contractor has made in advance of acquiring the aircraft, justification presented to the approving authorities within the company, the contractor's decision, and the implementing procedures adopted. Corporate aircraft costs, once the purchase or capital lease is made, are very much like sunk costs and cannot be rapidly altered by management decision. It is particularly important for the auditor to recommend that the contracting officer not approve the proposed acquisition of the

aircraft unless the contractor can demonstrate the cost-effectiveness of corporate aircraft.

f. When an advance agreement allows only a portion of the corporate aircraft costs, the auditor should recommend that the advance agreement clearly state that allowable cost of money will also be limited to the proportionate amount. This is consistent with the instructions for the form referred to in CAS 414-50(a). These instructions require that the facilities capital values be the same values as those used to generate the depreciation or amortization that is allowed for Federal Government contract costing purposes.

7-1003.4 Reasonableness of Contractor-Owned, -Leased, or -Chartered Aircraft Costs

a. In situations where all or part of travel costs via private aircraft in excess of the standard commercial airfare are approved by the contracting officer (see 7-1003.3), such costs are subject to the determination of reasonableness and allocability. Costs of private aircraft include costs of lease, charter, depreciation, cost of money, operation (including personnel), maintenance, repair, insurance, and all other related costs.

b. A corporate aircraft is sometimes used for nonbusiness or otherwise unallowable activities. The contractor is required under CAS 405 and FAR 31.201-6 to identify all unallowable costs. The auditor should review the flight manifest/log to determine whether the contractor has excluded the amount allocable to any travel for nonbusiness or otherwise unallowable activities. If the trip is considered unallowable, the auditor should calculate the related unallowable aircraft costs considering the entire costs of the aircraft, both fixed and variable costs.

c. The size, type, and number of aircraft maintained or chartered are major considerations in evaluating the reasonableness of the costs involved. The auditor should also review the flight manifest/log and other available documentation to determine whether optimum use is made of such aircraft to the extent that they are used for all suitable trips except where the variable costs involved in their use would exceed the trip cost by commercial airline.

d. Depreciation often represents the major item of contractor-owned aircraft costs. In evaluating it, the auditor should ensure that the allowable amount is determined in accordance with the provisions of FAR 31.205-11. Supplemental audit guidance on depreciation is at 7-400. Costs of aircraft overhaul and major component replacement, and their accounting treatment, also merit close audit scrutiny. If such costs are not capitalized and amortized by the contractor but are expensed in the period they are incurred, the auditor should assure that the procedure does not result in distorting the total aircraft costs for the period involved. Any gain or loss on the disposition of contractor-owned aircraft should be accounted for as provided in FAR 31.205-16.

e. Audit of private aircraft costs should include the evaluation of the propriety of the method used for their assignment or allocation to government contracts. When an aircraft is used exclusively by a particular organizational element, such as by the home office, division, or plant, the costs of the aircraft should be charged to that entity. When use is broader based, the aircraft costs should be distributed equitably to all of the user units. Some contracts may provide for travel costs as direct charges. In these cases, the auditor should assure that similar type costs are not duplicated as part of the allocation of aircraft costs to these contracts through overhead. Aircraft may also be used for non-travel purposes, such as instrument testing. Applicable costs should be charged directly to the benefiting projects.

7-1003.5 Contractor Responsibility

FAR 31.205-46(e)(2) specifically requires that the contractor must maintain documentation of all travel via private aircraft as a prerequisite of consideration for allowability of such costs. The contractor has the responsibility to support and justify the cost of aircraft usage. This responsibility includes:

(1) identification of all costs associated with private aircraft,

(2) submission of a comparative analysis of costs of private aircraft and standard commercial airfares, and

(3) maintenance of a flight manifest/log.

Costs that are unsupported as a result of a contractor's inability or unwillingness to furnish the required documentation should be disallowed.

7-1003.6 Maintenance of a Flight Manifest/Log by Contractor

The flight manifest/log which the contractor is required to maintain, plus other necessary backup data, should be in sufficient detail to serve as a source of support for its proposed costs. At least the following information for each flight should be provided:

(1) Date, time, and point of departure (airport).

(2) Date and time of arrival, and destination (airport).

(3) Names of pilot and crew.

(4) For each passenger aboard:

- Name.
- Name of company or organization represented.
- Position held in company or organization.
- Authorization for trip.
- Purpose of trip.

7-1004 Employee Relocation Costs

7-1004.1 General

a. The cost principle for allowability of relocation costs is FAR 31.205-35. It defines relocation costs as costs incident to the permanent change of duty assignment for a period of 12 months or more of an existing employee or upon recruitment of a new employee. Relocation costs are usually comprised of:

(1) cost of travel and transportation of household goods for the employee and immediate family members,

(2) cost of advance trips to find a permanent residence,

(3) closing costs (including state and local transfer taxes) incidental to sale of prior residence,

(4) expenses such as the costs of cancelling an unexpired lease and rental differential payments,

(5) costs for acquisition of new house,

(6) continuing mortgage interest at the old residence,

(7) interest differential between the old and new mortgage and rental differential payments where the relocated employee retains ownership of a vacated home in the old location and rents at the new location, and

(8) miscellaneous expenses.

Costs of travel for the employee and the employee's family to the new duty station and for house hunting trips include per diem costs which are also subject to FAR 31.205-46. (See 7-1002.3.)

b. The costs of relocating an employee are generally substantial. Evaluation of the contractor's policies and procedures as well as employment agreements as to reasonableness and compliance with FAR requirements is an important step of any audit program when significant costs are charged to government work. The allocation methods should be reviewed to determine that proper costs are being charged to benefiting contracts. In this regard, relocation costs should generally be charged to the receiving segment. Tests of individual personnel actions should be included to determine if established practices are being followed. When the contractor's policies and procedures are inadequate to control the incurrence of and accounting for unallowable costs, individual voucher testing must determine if the costs are allowable in accordance with FAR 31.205-35.

7-1004.2 Conditions for Allowability of Relocation Under FAR 31.205-35

a. The contractor's relocation costs must be reasonable and allocable, and must meet the four criteria listed in FAR 31.205-35(b) to be allowable. FAR 31.205-35(a) lists specifically allowable relocation costs and 31.205-35(c) lists expressly unallowable costs.

b. Allowable relocation costs for an existing or new employee must involve a permanent change of duty assignment. Relocation assignments should normally last at least 12 months. When an undue

number of such relocation assignments are terminated or completed in less than 12 months, the auditor should evaluate the reasons and recommend remedial action if appropriate. Relocation costs in excess of constructive temporary duty assignment costs should be questioned if the contractor should have known at the time of the assignment that it would not continue for a period of 12 months or more.

c. Failure to fulfill the 12-month requirement of a permanent change of duty assignment agreement for reasons within the employee's control requires the contractor to refund or credit the relocation costs to the government (FAR 31.205-35(d)). The auditor should encourage contractors to include recapture provisions in relocation agreements if this is not a practice. The provision should then be monitored by the auditor to assure that an adequate contractor follow-up system is in place to collect refunds when appropriate. The auditor should assure that a proper portion of any such refunds is credited to the government. However, the contractor is required to make appropriate refunds to the government whether or not the contractor recovers relocation payments from the employee.

d. Per FAR 31.205-35(f)(4), the recapture rule is not applicable to return relocation costs of a new employee who: (1) is hired specifically for a long-term (at least 12 months) field project or contract assignment; (2) is entitled to return relocation under the terms of his or her employment contract; and (3) is not a permanent employee and is released from employment upon completion of the assignment for which he or she was hired. This exception is applicable to only those employees who meet all three requirements. Accordingly, it is not applicable to the existing employees who are reassigned to field projects.

7-1004.3 Applicability of Joint Travel Regulations (JTR) to Relocation Per Diem Costs.

The FAR 31.205-46 allowable maximum government travel regulation per diem rates for lodging, meals and incidental expenses apply to contractor employees while traveling on official company business. House hunting trips and travel to the new duty station are considered official business travel and subject to the FAR 31.205-46 per diem criteria. These criteria do not apply to temporary quarters allowances because the employee is not considered to be on official business travel while in temporary quarters.

7-1004.4 Employee Assignments not Covered by the Relocation Cost Principle

Certain duty assignments, principally overseas locations, are accompanied by "location allowances." These "location allowances" represent compensation in addition to normal wages and salaries that are paid by contractors to induce employees to undertake or continue work at locations which may be isolated or in an unfavorable environment. Such allowances do not constitute relocation costs covered by FAR 31.205-35. They are considered a part of "compensation for personal services" by provision of FAR 31.205-6. They should be evaluated using the procedures described in 5-808. Also costs of travel to an overseas location should be considered travel costs in accordance with FAR 31.205-46 and not relocation costs if dependents are not permitted at that location for any reason and the costs do not include costs of transporting household goods. Under these circumstances the move is considered a temporary rather than a permanent change of duty station.

7-1004.5 Unallowable Relocation Cost

a. The allowability provisions of FAR 31.205-35 are significantly different between contracts awarded prior to July 29, 2002 and contracts awarded after that date. The substantive changes in the cost principle are:

(1) Payments for house hunting trips and temporary lodging are limited to a maximum of 60 days for the employee and 45 days for spouse and dependents for contracts awarded prior to July 29, 2002 (FAR 31.205-35(a)(2)). For contracts awarded after that date, these payments are limited only through the general reasonableness provisions in FAR 31.201-3.

(2) Payments for increased employee income or FICA taxes related to relocation reimbursements (commonly referred to as tax gross-ups) are expressly unallowable on contracts awarded prior to July 29, 2002 per FAR 31.205-35(c)(4). For contracts awarded after that date, tax gross-ups are specifically allowable per FAR 31.205-35(a)(10).

(3) Payments for spouse employment assistance are expressly unallowable on contracts awarded prior to July 29, 2002 per FAR 31.205-35(c)(5). For contracts awarded after that date, the costs are specifically allowable per FAR 31.205-35(a)(11).

(4) Lump-sum reimbursement of miscellaneous expenses (FAR 31.205-35 (b)(4)) on contracts awarded prior to July 29, 2002 is limited to $1,000. For contracts awarded after that date, the limit is raised to $5,000.

b. In addition to the allowability of the costs discussed in a. above, FAR 31.205-35(c) lists several other types of costs that are not allowable, regardless of the date of contract award. These unallowable costs include

(1) loss on the sale of a home;

(2) continuing mortgage principal (not interest) payments on the residence being sold;

(3) certain costs incident to the acquisition of a new home as shown in FAR 31.205-35(c)(2); and

(4) costs incident to furnishing or obtaining equity, nonequity, or lower-than-market-rate loans to employees.

In addition, FAR 31.205-35(d) requires the contractor to refund or credit contract costs for amounts previously charged to relocate an employee if the employee resigns for voluntary reasons within 12 months after relocation. Termination of employment for illness, disabling injury, or death is not generally within the employee's control and, therefore, would not serve as a basis for compelling contractors to refund or credit relocation costs to the government.

7-1004.6 Mass Relocations

a. Large scale or mass relocation of employees may result in abnormal total relocation costs. FAR 31.205-35(e) recognizes that questions may arise as to the reasonableness and allocability of the total amount, even though the items comprising the total are otherwise allowable. Thus FAR 31.109, Advance Agreements, provides the means by which parameters of reasonableness and allocability of special or mass relocation may be agreed upon in advance between the government and the contractor. In absence of an advance agreement, the provisions of FAR 31.2, should be used by the auditor for determination of reasonableness and allocability.

b. If the auditor learns that large scale employee relocations are to be made which may result in significant costs to prospective or existing government contracts, the auditor should report the matter to the cognizant ACO with a recommendation for an advance agreement regarding the allowability of such costs. The recommendation should cite important areas for agreement such as:

(1) the segments of the company among which the costs are to be equitably distributed,

(2) the length of time over which the costs are to be amortized, and

(3) the employees eligible for reimbursement of relocation costs.

After coordination with the local ACO, the auditor should provide any needed information to other contracting officers who are concerned.

c. Depending on the circumstances, as covered in FAR 31.109, an advance agreement may be negotiated by the local ACO, the CACO, or a PCO. Be responsive to any request from the designated government negotiator for audit assistance in establishing the negotiation objective.

7-1004.7 State and Local Transfer Tax

Some state or local governments may impose taxes on sales of homes. If the tax is imposed on the seller (employee) by law, it is considered a form of transfer tax which must be satisfied before the sale can be consummated and would qualify as closing costs described in FAR 31.205-35(a)(3). However, agreement to pay the tax not imposed on the seller by law, in the interest of making a sale or for other reasons, would not qualify as an item of closing costs and would be unallowable.

7-1100 Section 11 --- Dues, Membership Fees and Professional Activity Costs

7-1101 Introduction

a. This section provides basic guidance in reviewing dues, memberships, and professional activity costs (FAR 31.205-43).

b. Additional guidance is provided on costs of memberships in industrial liaison programs of universities, the Army, Navy, and Air Force associations, and organizations engaged in lobbying or charitable activities.

7-1102 Dues, Memberships, and Subscription Costs

7-1102.1 General

a. Generally, costs of memberships in trade, business, technical, and professional organizations are allowable per FAR 31.205-43(a) but see 7-1102.2, 7-1102.3, 7-1102.4, and 7-1102.6 below for special considerations.

b. Subscription costs include trade, business, professional, or technical periodicals. Such costs are generally allowable per FAR 31.205-43(b).

7-1102.2 Army, Navy, and Air Force Associations

The Association of the United States Army, Army Aviation Association of America, Navy League of the United States, Air Force Association, and other nonprofit associations with similar objectives have for many years offered memberships to contractors. These associations are primarily concerned with fostering and preserving the images and efficiencies of the Army, Navy, and Air Force. They operate outside government channels in an endeavor to preserve a spirit of fellowship among former and present Service members and to inform and arouse the interests of the public in activities and achievements of their respective military services. Generally, memberships are offered to contractors that wish to support the objectives of these associations. The membership dues often include a subscription to publications issued periodically. For example, the Association of the United States Army monthly publishes a magazine entitled ARMY. It includes numerous articles primarily designed to enhance Army personnel programs and to promote manpower and combat readiness. In addition, conventions and meetings are periodically held by these associations, at which contractors frequently exhibit their products. Occasionally, these conventions or meetings will be sponsored by a contractor or group of contractors. These conventions or meetings are usually held to focus the attention of the public on the activities of a particular military service that contribute to national defense programs. In determining the allowability of costs incurred by contractors with these associations, the auditor will be guided by the following:

a. Costs related to these associations such as membership fees, exhibit or display costs, and sponsorship expenses do not qualify as allowable under the trade, business, technical, or professional activity principle in FAR 31.205-43.

b. The costs of travel, registration, hotel, and other expenses incurred in connection with these associations' conventions, meetings, and conferences are considered unallowable in accordance with FAR 31.205-43(c), unless the contractor can show that the primary purpose of the meeting is for "the dissemination of technical information or the stimulation of production." The inference here is that the technical information will benefit performance, or stimulate production, under a particular government contract, or series of contracts.

7-1102.3 Costs of Memberships in Industrial Liaison Programs of Universities

Industrial liaison programs are offered to contractors by various universities throughout the country. Under such programs, contractors are usually entitled to the use of university facilities, consultations with faculty members, copies of research reports, attendance at symposiums, and possibly other benefits. To become eligible for such benefits, the universities require that contractors pay membership fees. Some universities enter into formal agreements with contractors

describing the types of benefits that will be provided.

a. The membership fee in each industrial liaison program, as further discussed in b. below, should be considered a retainer fee under FAR 31.205-33 and an allowable cost if supported by evidence that: (1) the services are necessary and customary; (2) the level of past services justifies the amount; and (3) the retainer fee is reasonable compared to the cost and level of expertise required to maintain an in-house capability to perform the covered services.

b. Normally, benefits available from membership in an industrial liaison program are the same for all members, regardless of fee paid by each member. Universities usually set a schedule of fees based on company size which is often based on voluntary compliance or negotiation above the minimum fee. Generally, amounts paid in excess of the minimum fee are voluntary and should be disapproved as contributions under FAR 31.205-8, in the absence of evidence to the contrary. However, a larger company or one with a special need may derive more benefits than other industrial liaison program members. In such cases, all or a portion of the amount above the minimum fee may be allowable.

7-1102.4 Costs of Membership Fees in Organizations Engaged in Lobbying or Charitable Activities

The allowability of membership fees, association dues, or the costs of donated time or materials to any organization can normally be determined from the primary mission of the organization receiving the payments or benefits. We believe that all organizations fit three basic categories and that the allowability of associated costs is predicated on the nature and materiality of expenses.

a. Bona Fide Trade or Professional Organizations

If an organization is formed for the basic purpose of providing technical services to member contractors and the contractors can demonstrate that such services were actually received, the membership and associated costs are normally allowable, even though the organization may occasionally engage in an immaterial amount of lobbying activities or charitable endeavors.

b. Trade or Nonprofit Organizations Partially Engaged in Lobbying or Charitable Activities

The costs of membership or other support activities donated or supplied to organizations which are partially engaged in lobbying or charitable endeavors should be examined in light of their nature, purpose, and materiality. There is no hard and fast rule to apply to these conditions in order to objectively determine the extent of unallowable costs attributed to association with certain organizations. Therefore the following steps should be taken in order to provide reasonable assurances that unallowable contributions or lobbying costs are not billed or claimed by contractors when they are commingled with other allowable costs:

(1) Question any special assessment or separately identified portion of the costs of membership fees or other type costs applicable to lobbying or charitable activities as unallowable.

(2) Notify the contractor that it is responsible for the identification and removal from its claims and proposals of any unallowable activity costs and that it is required to maintain adequate records to demonstrate compliance with applicable cost principles.

(3) In the absence of documentation as to the amount of unallowable lobbying or charitable activities performed by such organizations, it may be difficult to question estimated unallowable activities. The auditor should request the contractor to obtain from the organization in question a confirmation letter identifying or estimating the amounts or percentages of lobbying or charitable effort expended by the organization in the accounting year being audited.

c. Organizations Dedicated to Lobbying or Charitable Activities

When it can be determined that the fees or other type costs associated with membership in these organizations are ultimately expended on lobbying or charitable activities, the costs are to be evaluated for allowability under FAR 31.205-8, or 31.205-22.

7-1102.5 Costs of Political Campaign Activities at Contractor Facilities

Costs associated with political campaign activities, such as candidates' appearances and speeches at contractor facilities, are unallowable in accordance with FAR 31.205-22(a)(1), Legislative Lobbying Costs, when such activities are clearly an attempt by the contractor to influence the outcome of an election by soliciting votes. The key considerations in this determination are how the candidate is portrayed by the contractor and the subject matter of the candidate's speech. When questioning such an event all costs associated with these activities including applicable burdens should be questioned.

7-1102.6 Contributions Claimed as Dues or Subscriptions

When auditing dues and subscription accounts auditors should be alert for any contributions paid separately or included as part of the billing. Professional organizations often include a suggested voluntary contribution as part of the membership dues. If the contractor receives something in return for the contribution (e.g., professional publications) it is the contractor's responsibility to establish the value of the product or service received. The value of goods or services received is not a contribution; it is a purchase. The amount in excess of the value established is an expressly unallowable contribution under FAR 31.205-8.

7-1103 Professional Activity Costs

7-1103.1 General

a. Paragraph (c) of FAR 31.205-43, Trade, Business, Technical and Professional Activity Costs states that the cost of technical or professional meetings and conferences are allowable when the primary purpose of the meeting is the dissemination of trade, business, technical or professional information or the stimulation of production or improved productivity, provided the costs meet the other requirements controlling allowability (FAR 31.201-2).

b. The cost principle makes the following type of professional and technical activity costs expressly allowable:

(1) Organizing, setting up, and sponsoring the technical and professional meetings, symposia, seminars, etc., including rental of meeting facilities, transportation, subsistence, and incidental costs.

(2) Attending the meetings by contractor employees, including travel costs. (See FAR 31.205-46)

(3) Attending the meetings by individuals who are not contractor employees, provided the costs are not reimbursed to them by their own employer and their attendance is essential to achieve the purpose of the meetings.

7-1103.2 Conference Costs versus Entertainment Costs

a. Determinations as to whether or not expenses associated with a particular meeting or conference represent allowable business expense under FAR 31.205-43(c) provisions or unallowable social activity under FAR 31.205-14 (Entertainment Costs) should be made on a case-by-case basis, based on all pertinent facts.

b. Under the provision of FAR 31.205-43(c)(3), costs associated with the spouse of an attendee are not allowable because the spouse's attendance is not essential to achieve the purpose of the meeting.

7-1103.3 Business Meals

a. For individuals on official travel, assure the meal expense is not included in both the claimed travel costs and subsistence costs included as part of organizing the meeting.

b. For individuals not on official travel, assure that any meal expense is an integral part of the meeting as described in FAR 31.205-43(c), necessary for the continuation of official business during the meal period, and not a social function.

7-1103.4 Documentation

a. Determination of allowability requires knowledge concerning the purpose and nature of activity at the meeting or

conference. The contractor should maintain adequate records supplying the following information on properly prepared travel vouchers or expense records supported by copies of paid invoices, receipts, charge slips, etc.

(1) Date and location of meeting including the name of the establishment.

(2) Names of employees and guests in attendance.

(3) Purpose of meeting.

(4) Cost of the meeting, by item.

b. The above guidelines closely parallel the current record-keeping requirements in Section 274 of the Internal Revenue code for entertainment costs as a tax deductible expense. Where satisfactory support assuring the claimed costs are allowable conference expenses is not furnished, the claimed conference/meal costs and directly associated costs (see 8-405.1d. for description) should be questioned.

7-1103.5 Standards of Conduct --- Federal Employees

Guest expenses for meals or other incidentals applicable to Federal employees should normally be questioned as unnecessary, and hence unreasonable costs, except under limited circumstances, since they are prohibited from accepting gratuities by Executive Order 11222 of 1965, Title 5 CFR 2635, and various departmental implementing directives (e.g., DoDD 5500.7, "Standards of Conduct").

7-1200 Section 12 --- Public Relations and Advertising Costs

7-1201 Introduction

This section provides supplemental guidance on audits of public relations and advertising costs including publications. The guidance in Chapters 2 through 6, 8, and 9 also applies to these areas.

7-1202 Applicability of FAR

FAR 31.205-1 defines and addresses the allowability of public relations and advertising costs.

7-1202.1 Definition of Public Relations and Advertising

Public relations and advertising costs include the costs of media time and space, purchased services performed by outside organizations, as well as the applicable portion of salaries, travel, and fringe benefits of employees engaged in the functions and activities identified in the FAR definitions of public relations and advertising.

a. Public Relations

Public relations as defined in FAR 31.205-1(a) means all functions and activities dedicated to:

(1) Maintaining, protecting, and enhancing the image of a concern or its products; or

(2) Maintaining or promoting reciprocal understanding and favorable relations with the public at large, or any segment of the public. The term public relations includes activities associated with areas such as advertising and customer relations.

b. Advertising

(1) Advertising as defined in FAR 31.205-1(b) means the use of media to promote the sale of products or services and to accomplish the activities referred to in FAR 31.205-1(d) (see 7-1202.2a) regardless of the medium employed, when the advertiser has control over the form and content of what will appear, the media in which it will appear, and when it will appear.

(2) Advertising media include but are not limited to conventions, exhibits, free goods, samples, magazines, newspapers, trade papers, direct mail, dealer cards, window displays, outdoor advertising, radio, and television.

7-1202.2 Allowability of Public Relations and Advertising Cost

FAR provisions 31.205-1(d), (e), and (f) address the allowability of public relations and advertising costs. These provisions and supplemental audit guidance are provided in the following paragraphs:

a. Advertising Costs

All advertising costs other than those specified in FAR 31.205-1(d) are unallowable. Allowable advertising costs include:

(1) Costs that arise from requirements of government contracts and that are exclusively for:

(a) Acquiring scarce items for contract performance; or

(b) Disposing of scrap or surplus materials acquired for contract performance. If incurred for more than one government contract or both government and other work of the contractor, costs of this nature are allowable to the extent that the principles in FAR 31.201-3 (reasonableness), FAR 31.201-4 (allocability), and FAR 31.203 (allocation of indirect costs) are observed.

(2) Costs to promote sales of products normally sold to the U.S. government that contain a significant effort to promote exports from the United States. See 7-1202.2g.

(3) Costs that are allowable in accordance with FAR 31.205-34, Recruitment Costs. See 7-2104.

b. Contract Requirements

Advertising and public relations costs specifically required by contract are allowable.

c. Liaison Cost

(1) Allowability of Liaison Costs

Allowable public relations costs include cost incurred for (a) responding to inquiries on company policies and activities; (b) communicating with the public, press, stockholders, creditors, and customers; and (c) conducting general liaison with news media and government public relations officers, to the extent that such activities are limited to communication and liaison necessary to keep the public informed on

matters of public concern such as notice of contract awards, plant closings or openings, employee layoffs or rehires, and financial information.

(2) Audit Evaluation

(a) Public relations costs may encompass (i) services performed in-house, possibly in a public relations or similarly designated department, by the contractor's own employees; and (ii) services performed by the contractor's own employees at any offsite liaison office. Public relations costs incurred in-house and offsite include the salaries and related travel and fringe benefits of the employees involved and an allocable share of supervision, space, utilities, and administration costs. Audit evaluation of public relations costs should encompass all of the foregoing aspects.

(b) The costs of offsite liaison/public relations offices are often substantial and the contractor's in-house records may not be sufficient to permit the necessary scope of audit of such costs. This condition would call for additional audit effort at the offsite facility to the extent required to determine the allowability, allocability, and reasonableness of the costs incurred by that facility.

d. Community Service Activities

(1) Costs of participation in community service activities such as blood bank drives, charity drives, savings bond drives, and disaster assistance are allowable.

(2) Under FAR 31.205-8, contributions and donations, whether in the form of money, goods, or services, are unallowable. However, the costs of services of executive and other personnel in support of charitable and community funds or other similar campaigns or drives are allowable under FAR 31.205-1(e)(3) and should not be questioned. When such services affect the concurrent full discharge of their other regular duties and responsibilities to the contractor by the personnel involved, the auditor should consider whether the costs are reasonable.

(3) Employee Leave Donation Programs

On February 11, 2002, the Director, Defense Procurement (DDP) issued a memorandum regarding the allowability of contractor payments to charitable organizations, such as those helping victims of the September 11, 2001 attacks, for the value of leave donated by employees. DDP concluded that such payments for vacation and personal leave, but not sick leave, represent an allowable compensation cost under FAR 31.205-6, Compensation for personal services, rather than an unallowable contribution under FAR 31.205-8, Contributions or donations. Such costs are considered compensation costs for government contract costing purposes regardless of the contractor’s classification of the costs for tax or financial accounting purposes. Such treatment will be considered appropriate for payments made prior to January 1, 2003. The DDP conclusion was based on the Internal Revenue Service (IRS) ruling that employee donations of leave made before January 1, 2003 do not constitute taxable income to the employee and that employers may treat these employee donations as either ordinary and necessary business expenses or charitable contributions. On December 12, 2002, the Director, Defense Procurement and Acquisition Policy (DPAP, formerly DDP) issued a memorandum stating that this treatment will not be extended to payments made after December 31, 2002. Therefore, contractors must record employee donations of vacation and personal leave made after December 31, 2002 as compensation costs.

e. Plant Tours and Open Houses

Costs of plant tours and open houses are allowable; however, costs of promotional material, motion pictures, videotapes, brochures, handouts, magazines, and other media that are designed to call favorable attention to the contractor and its activities are unallowable under FAR 31.205-1(f)(5) (see 7-1202.2i).

f. Ceremonial Costs

Costs of ceremonies such as corporate celebrations and new product announcements are unallowable. Costs of keel laying, ship launching, commissioning, and roll-out ceremonies, to the extent specifically provided for by contract, are allowable.

(1) Ship Launching Ceremonies

Items of cost which are normally acceptable for ship launching ceremonies include (a) the construction of a minimum-size launching platform large enough to accommodate the launching party and

speakers; (b) modest decorations of the launching platform and a sponsor's shelter, if needed; and (c) a bottle of champagne, decorative ribbon and suspension, and a simple decorative packing case without metal container.

(2) Sponsor's Costs

Costs related to personal expenses of the sponsor and its party, luncheons or dinners, and gifts for the sponsor are unallowable and should be questioned.

g. Air Shows, Special Events, and Trade Shows

Generally, air shows and trade shows are classified as broadly targeted selling efforts and are covered under FAR 31.205-1. However, the allowability of these costs has been complicated by numerous changes effected through the public laws to the regulations. These costs are classified as allowable or unallowable on contracts depending on when the costs were incurred.

In determining the allowability of air shows, special events, and trade shows, auditors must pay specific attention to the contract award date, when the costs were incurred, and the governmental agency purchasing the goods and services. The chart below assists in identifying the applicable allowability criteria. The numbers are keyed to the following six paragraphs in this subsection. Advertising costs of air shows, special sales events, and trade shows with no foreign sales (export) value have been and still are unallowable costs. Likewise, entertainment costs and other costs not necessary to a sales presentation have always been and still are unallowable. For additional information on the allowability of foreign selling costs, see the chronology presented in 7-1306.2.

5/16/97 - Current	(1)	(1)
5/15/91 - 5/15/97	(2)	(2)
4/12/88 - 5/15/91		
Costs incurred on or after the start of the contractor's 1st fiscal year beginning on or after 12/15/88	(3)	(4)
Costs incurred prior to the start of the contractor's 1st fiscal year beginning on or after 12/15/88	(4)	(4)
Prior to 4/12/88	(5)	(6)

(1) Costs of "significant effort" to promote export sale of product normally sold to the U.S. government are allowable. This includes air shows, trade shows, and special events.

(2) Costs of "significant effort" to promote export sale of products normally sold to the U.S. government are allowable subject to a ceiling. This includes air shows, trade shows, and special events.

(3) (a) For DoD contracts open as of 5/15/91, (2) is retroactively applied to fiscal years beginning on or after 12/15/88.

(b) For DoD contracts open as of 12/15/88 but closed prior to 5/15/91, costs of "significant effort" to promote export sales of U.S. defense industry products were allowable subject to a ceiling. DoD contracts have specific coverage in the DFARS that is applied in place of the FAR coverage. The FAR coverage remained applicable to non-DoD contracts as discussed in (4) below. For these DoD contracts, DFARS 231.205-1 and 231.205-38 provided that the costs of activities which contain "significant efforts" to promote exports of U.S. defense industry products are allowable. Such promotional activities primarily targeted at foreign selling are allowable even if they include domestic marketing efforts. Additional information regarding ceiling limitations and the effective dates are in 7-1306.2(d).

(4) The following costs to promote American aerospace exports at domestic and international exhibits, such as air shows, trade shows, and conventions, were allowable provided they were reasonable:
Transportation of the aircraft;
Aerospace parts and equipment;
Other associated support cost.

(a) These allowable costs did not include other exhibit costs (such as cost of entertainment, hospitality suites or chalets, advertising media other than exhibits, and other costs not necessary to establish, operate, or maintain an exhibit, display, or demonstration).

(b) In addition, the allowability coverage was limited to promoting a specific category of products (i.e., American aerospace products) to a specific class of customers (i.e., foreign customers). Accordingly, costs incurred for promoting a contractor's non-aerospace products at an

international trade show, and that portion of costs incurred for promoting a contractor's aerospace products to American customers, were unallowable (Section 8062 of the 1988 Appropriations Act).

(5) For DoD contracts awarded prior to April 12, 1988 and completed before the start of the contractor's first fiscal year beginning on or after December 15, 1988, air shows, trade shows, and conventions were generally unallowable. However, for DoD contracts awarded prior to April 12, 1988 and still in progress on or after the start of the contractor's first fiscal year beginning on or after December 15, 1988, air shows, trade shows, and convention costs are generally allowable as described in (2) and (3). On such in-progress contracts awarded prior to April 12, 1988, the costs of air shows, trade shows, and conventions incurred in prior fiscal years remain generally unallowable. This type of change in the applicability of the cost principles based on the timing of cost incurrence is unusual. It was mandated by Public Law 100-456. These costs are allowable subject to a ceiling, which is described in 7-1306.2.

(6) For contracts with the U.S. government other than with DoD awarded prior to April 12, 1988 and completed prior to May 15, 1991, air shows, trade shows, and conventions were generally unallowable. However, for non-DoD contracts awarded prior to April 12, 1988 and still in progress on or after May 15, 1991, air shows, trade shows, and convention costs are generally allowable as described in (2) if incurred on or after May 15, 1991. These costs are allowable subject to a ceiling, which is described in 7-1306.2.

(7) Audit Guidance

(a) Contracts awarded in the period discussed in 7-1202.2g(1), (2), and (3) do not require the segregation of promotional costs based on targeted customers. The provisions make allowable significant effort primarily targeting the promotion of exports even though domestic marketing efforts are included.

(b) For all contracts awarded in the period discussed in 7-1202.2g(4) the contractor must be able to document that the products are American aerospace products and that the targeted customers are foreign. Certain trade shows or exhibits target a mixed customer audience (both foreign and American customers). When an event targets both types of customers, only a portion of the costs (those targeting foreign customers) is considered allowable. FAR 31.204, Application of principles and procedures, requires the contractor to assign costs targeting domestic customers as unallowable and costs targeting foreign customers as allowable. The auditor should review the contractor's documentation and assumptions.

h. Meetings, Symposia, Seminars, and Other Special Events

Costs of sponsoring meetings, symposia, seminars, and other special events when the principal purpose of the event is other than dissemination of technical information or stimulation of production are unallowable.

i. Promotional Material

Costs of promotional material, motion pictures, videotapes, brochures, handouts, magazines, and other media that are designed to call favorable attention to the contractor and its activities are unallowable.

j. Souvenirs, Models, and Mementos

Costs of souvenirs, models, imprinted clothing, buttons, and other mementos provided to customers or the public are unallowable.

k. Costs of Memberships

(1) FAR Provision

Costs of memberships in civic and community organizations are unallowable.

(2) Audit Guidance

Allowable costs of memberships in trade, business, technical, and professional organizations (FAR 31.205-43) include dues paid to Chambers of Commerce. Dues paid to Army, Navy, and Air Force Associations are unallowable (7-1100). The minimum fee for membership in any university's industrial liaison program is allowable if reasonable, provided it is supported by evidence of bona fide services available or rendered (7-1100). Expenditures for influencing legislation are unallowable by Federal statute. Any identifiable portion of the costs of memberships in bona fide trade, business, technical, and professional organizations, intended for use in connection with influencing legislation is likewise unallowable (FAR 31.205-22).

l. Other Public Relations Costs to Promote Sales

Under FAR 31.205-1(f)(1), unallowable public relations costs include all public relations costs other than those specified in FAR 31.205-1(e) whose primary purpose is to promote the sale of products or services by stimulating interest in a product or product line (except for those direct selling costs made allowable under FAR 31.205-38(c)), or disseminating messages calling favorable attention to the contractor for purposes of enhancing the company image to sell the company's products or services.

7-1203 Public Relations Costs

7-1203.1 Contractor's Accounting Systems

Public relations consists of different types of materials and services which by themselves may be separately treated in FAR 31.205. Moreover, many contractors do not establish public relations as a separate category of cost in their accounting systems. Although they may be recorded in other accounts, public relations costs are most likely to be found as part of:

a. Advertising Costs (FAR 31.205-1).

b. Compensation for Personal Services (FAR 31.205-6).

c. Contributions and Donations (FAR 31.205-8).

d. Employee Morale, Health, Welfare and Food Service and Dormitory Costs and Credits (FAR 31.205-13).

e. Entertainment Costs (FAR 31.205-14).

f. Labor Relations Costs (FAR 31.205-21).

g. Other Business Expenses (FAR 31.205-28).

h. Professional and Consultant Service Costs-Legal, Accounting, Engineering and Other (FAR 31.205-33).

i. Selling Costs (FAR 31.205-38).

j. Trade, Business, Technical and Professional Activity Costs (FAR 31.205-43).

7-1203.2 Review of Public Relations Costs

Contractor expenditures for public relations and advertising activities identified in FAR 31.205-1(f) (see 7-1202.2) and those which meet the criteria for contributions and donations, or entertainment costs are unallowable under the cited FAR provisions. The extent of and criteria for allowability of the other above listed cost categories are expressed in the identified FAR paragraphs. Appropriate audit steps should be designed to identify public relations items in each category and to evaluate their allowability.

a. Factors to be Considered

When reviewing the different categories of costs, the most important major factors to be considered are the nature of the service rendered, the function performed, the propriety of the base of allocation, and the basic consideration of reasonableness as defined in FAR 31.201-3. Nomenclature or similar less-than-in-depth audits are apt to result in an incorrect determination.

(1) Nature of Services Rendered and Functions Performed

The nature of the service rendered and the function performed are important in determining the proper classification of costs. FAR 31.204(c) 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. This FAR provision prevents contractors from successfully claiming unallowable public relations costs under more favorable and broader cost principle coverage; e.g., unallowable costs of ceremonies (FAR 31.205-1(f)(4)) claimed as employee morale and welfare under FAR 31.205-13 (but see 7-2117.3).

(2) Reasonableness and Allocability of Costs

(a) The auditor should be primarily concerned with the positive criteria of allowability, reasonableness and allocability. Costs will generally be considered reasonable if they are of a type normally recognized as ordinary and necessary for the contractor's business, or are the actions of a prudent businessman in the conduct of competitive business. On the other hand, costs which represent a significant deviation from established business practices, increasing contract costs, are likely to be unreasonable.

(b) The reasonableness of costs should also be viewed from the standpoint of magnitude. Careful scrutiny should be given to large amounts of public relations expenditures especially when there have been significant increases relative to the base from prior years. This is particularly true when most of the contractor's costs are allocated to government contracts. Accordingly, where amounts appear to be disproportionately large or otherwise out of line, the auditor should consider questioning costs as appropriate, even though they fall within allowable classifications.

b. Special Audit Considerations

Special audit considerations for certain other items of public relations cost are summarized below.

(1) Government Requested Public Relations and/or Advertising Activities

The types of public relations and advertising costs which are unallowable, and the limited ones that are allowable, are set forth in FAR 31.205-1. Even in instances where a contractor is satisfying a contract related suggestion or request by government contracting personnel, a public relation or advertising cost that is classified as unallowable by this section remains unallowable. However, FAR 31.205-1(d) provides the contracting officer with the latitude to request public relation or advertising effort when needed to meet contract requirements. To be allowable, the public relations and/or advertising activity must be specifically required by contract or modification. Unallowability would also extend to the costs of exhibits in which the contractor is invited to participate by any agency of the government, and at which the company or its products are publicized for the purpose of delivering a sales message.

(2) Public Relations Account

The auditor may occasionally find a contractor that maintains an account entitled public relations. Such accounts should not be questioned/disapproved on a nomenclature basis; rather an adequate analysis of their contents should be made since they may contain both allowable and unallowable costs. FAR 31.201-6 incorporates Cost Accounting Standard (CAS) 405 which requires contractors to identify unallowable costs (see 8-405). The auditor should coordinate with the administrative contracting officer in obtaining necessary refinements in the contractor's accounting procedures to identify unallowable public relations costs.

c. Reporting

Public relations types of costs are particularly sensitive because of their controversial nature. Audit coverage should therefore be of commensurate scope and depth. Reasons given in audit reports for audit questioned or disapproved costs should be clear, precise, and complete.

7-1204 Publication Costs

Publication costs claimed by a contractor may include costs related to the preparation and printing of such items as plant newspapers and magazines, recruitment pamphlets, technical brochures, and contractor and product capability promotional items. While the amounts individually may not be significant, collectively on DoD procurements they amount to significant dollars.

7-1204.1 Audit Guidelines

a. Audits of claimed publications costs should be based on an appropriate examination of the contractor's policies and procedures (6-600), as well as on a selective review of individual publications. FAR specifically allows (within limitations) help wanted, scarce and scrap material advertising (31.205-1(d)); house publications (31.205-13), and corporate stockholders reports (31.205-28).

b. The allowability of the cost of any publication which is construed as public relations and/or advertising must be determined in accordance with FAR 31.205-1. Unfortunately, the contents of the publications do not always lend themselves to a ready determination as to the FAR category into which they fall. To assist in these determinations the following guidance sets forth five broad categories into which most publications may be grouped.

7-1204.2 Broad Categories Covering Publications

Examples of the types of publications to be included under each category and fac-

tors which indicate the appropriate section of FAR under which the allowability of the related costs should be determined are discussed below.

a. Employee Welfare and Industrial Relations

(1) The most common publications of this type are regularly issued newspapers or magazines. These publications generally provide information as to events of interest within the organization or of the employees' outside activities. Although there are frequently articles on company achievements, the intent here is to instill a feeling of accomplishment rather than to advertise. Other industrial relations publications incorporate information on available employee benefits, safety, and education. Distribution of the above types of publications is usually limited to immediate employees and/or their families. The related costs of the foregoing publications are considered allowable under FAR 31.205-13.

(2) Recruitment pamphlets which are used primarily to explain the available fringe benefits to prospective employees should be considered in conjunction with the review of help wanted advertisements and as such are allowable under FAR 31.205-1 subject to the limitations of FAR 31.205-34 (see 7-2104).

b. Professional and Technical Articles

(1) These publications are disseminated to a professional or technical type audience and generally take the form of dissertations on technical subjects that are related to the contractor's products or activities. This type of publication has generated much of DoD's interest in contractors' house publications. In most instances the costs of publishing such material can better be related to professional activity costs since they are the result of, or are copies of, papers delivered at professional meetings. Others are reprints of magazine articles of scientific interest.

(2) In evaluating individual publications of this nature, difficulty may be experienced in determining whether they should be classified as capability advertising or as technical treatises. Some difficulties will normally arise where there are subtle, even though infrequent, references to the contractor. Where such references are the only questionable aspect of the publication, it would be extremely difficult to support a position that these references necessitate consideration of the publication as an advertisement. Therefore, to the extent that the publication costs incidental to technical presentations at meetings and conferences and reprinting such technical papers for use in contractors' house publications are reasonable and allocable, and can be construed as dissemination of technical information rather than advertising, such publications are considered allowable within the intent of FAR 31.205-43.

c. Selling, Marketing, and Advertising

In those instances where the material provides little or no technical assistance to the recipient and is distributed to all customers and/or potential customers, the cost should be treated as advertising (FAR 31.205-1) or selling costs (FAR 31.205-38). More specific guidance in determining the allowability of selling costs is in 7-1300. Advertising costs of this nature are unallowable (see 7-1202.2a).

d. Contractor and Product Capability Promotional Items

(1) These differ from normal selling, marketing, and advertising publications in that they stress the superior capabilities of the contractor's facilities and/or personnel in research and/or development of new products. They may also advertise achievements of the contractor, but generally do not supply detailed technical data. Advertising costs of this nature are unallowable under FAR 31.205-1(f) (see 7-1202.2a). Accordingly, such costs should not be accepted under cost-type contracts and should be questioned in advisory audit reports for price negotiation purposes.

(2) Certain publications can be clearly identified as capability advertising; however, in some cases publications that provide technical data necessary for equipment operation may include some descriptive data that could be construed as capability advertising if taken out of context. The primary purpose of the publication and type of distribution, such as, operating manuals delivered with the equipment, would be the significant factor in determining allowability.

e. Public Relations

This category includes pictures, decals, and promotional material that em-

phasize the contractor's accomplishments in producing equipment or providing services. They do not contribute to the performance of the government contracts, even if they are related to items produced under such contracts, but merely serve to enhance the contractor's reputation. The costs of such items are unallowable (see 7-1202.2).

7-1205 Contractor Logos and Emblems

7-1205.1 Contracting Officers' Position

A common practice for a company is to identify its products using logos and emblems. Some contracting officers are concerned over the costs being incurred for contractors' logos and emblems being placed on government systems. These contracting officers are treating the direct and indirect costs for logos and emblems produced by means of a special mold or casting (not simple stick-on adhesive decals) as unallowable advertising costs under FAR 31.205-1.

7-1205.2 Audit Procedures

a. Applicable FAR Provisions

The contracting officers' position reflects an internal negotiating/contracting policy. This policy is enforceable to the extent that contracting officers obtain contractor concurrence and include a specific clause in contracts making such costs expressly unallowable or issue a notice of intent to disallow. Unless contracts contain such a clause, contractors need only comply with FAR 31.205-1 and FAR 31.201-3, Reasonableness.

b. The use of the terminology “logos and emblems” may be misleading. Logo is an abbreviation for the word logotype, which actually means the standard ways in which to letter or set in type the company trade name, while emblem represents the mark of a nonprofit organization. However, "contractor logos and emblems" as used in government contracting represent the actual design and typesetting of all company marks. Company marks can be trademarks (companies who manufacture products) or service marks (companies who provide services to their customers). Regardless of the type of mark, the key factor is the purpose for which the marks are designed. Marks are initially designed to meet three main purposes, (1) to indicate the origin of the product or service provided, (2) to guarantee quality consistency (the mark tells the buyer that the product or service is the same as that provided previously), and (3) to serve as an advertisement (simple enough to catch attention, complete enough to tell a story, and persuasive enough to move the viewer to action). When a company initially designs a mark, each of these three purposes are relevant. Therefore, disallowance of these costs under FAR 31.205-1 is generally not practicable. However, the initial design of logos and emblems may be challenged as unreasonable if costs are determined to be excessive.

c. While the initial design of a company mark cannot generally be questioned under FAR 31.205-1, the redesign can be. When a company redesigns its mark, the public is usually already familiar enough with the original mark to know the origin of the product; thus, this purpose is usually not relevant to a redesign. In addition, redesigning the mark does not serve to guarantee quality consistency, since the original mark already told the prospective buyer that the product or service is the same as that previously provided. However, redesigning the mark does serve as an advertisement, since it is intended to catch the attention of those who were previously unaware of the company, tell a story (a new one or the rephrasing of an old one), and be persuasive enough to move a viewer to take a form of action that the old mark could not. Thus, the major purpose of redesigning a company mark will usually be advertising; if this is the case, then these costs are unallowable under FAR 31.205-1.

d. A company mark may be redesigned for other reasons, such as a corporate merger, reorganization, etc. The auditor must carefully consider the purpose of redesigning the company mark in determining the allowability of such costs. For example, if the redesign results from a reorganization, then FAR 31.205-27, Organization Costs, should be considered in evaluating the allowability

evaluating the allowability of these costs. Furthermore, as was the case with the initial design, the redesign of logos and emblems may also be challenged as unreasonable if costs are determined to be excessive.

e. Audit Evaluation

(1) Auditors should continue to evaluate proposed advertising costs, including the redesign of logos and emblems, in accordance with the FAR. Excessive costs of logos and emblems, even those falling within allowable categories under the FAR provisions, should be questioned based on reasonableness.

(2) Comments may be included, as part of the applicable report exhibit note, on the effect of the contracting officer's position on proposed costs.

(3) FAOs should assure that the auditor's review of contract provisions (see 3-202) clearly identify special contract clauses disallowing the costs of logos and emblems. Audit programs for evaluation of direct and indirect costs should include steps to verify compliance with this and other contractual cost limitations.

7-1300 Section 13 --- Selling Costs

7-1301 Introduction

This section contains general audit guidance in determining the allowability, allocability, and reasonableness of selling costs under government contracts including:

a. Selling costs as discussed in FAR 31.205-38,

b. Selling costs under Foreign Military Sales contracts as discussed in DoD FAR Supplement (DFARS) 225.7303-2 and 225.7303-4, and

c. Contingent fees as discussed in FAR 3.400.

7-1302 General Audit Considerations

Selling expenses are subject to the same basic audit procedures and tests for allocability and reasonableness as manufacturing and administrative expenses. However, there are certain factors for special consideration. Where a significant amount of selling expense is involved there should be adequate tests of the individual items and accounts classified under this expense category to enable the auditor to fully understand (1) the type and size of the contractor's sales organization, (2) the basis of employee compensation, (3) the nature of the selling and distribution activities involved, (4) their relationship to the contractor's different operations, products or product lines, and (5) their applicability to government and commercial business. A nomenclature review of account titles is not sufficient for this purpose.

7-1303 Proper Classification of Selling Expenses

7-1303.1 Nature of Selling Effort

a. The nature of costs classified and charged as selling expense should be compatible with the provisions of FAR 31.205-38. The costs of such effort are considered allowable if reasonable in amount. Although the generic term "selling" encompasses all efforts to market a contractor's products, the acceptability of the costs of this effort are governed by several subsections of FAR 31.205. Costs that fall into the following categories should be classified accordingly. These costs should be evaluated using the appropriate subsection of FAR 31.205:

(1) Advertising costs (FAR 31.205-1). Also see 7-1200.

(2) Corporate image enhancement and public relations costs (FAR 31.205-1). Also see 7-1200.

(3) Bid and proposal/independent research and development costs (FAR 31.205-18). Also see 7-1500.

(4) Entertainment costs (FAR 31.205-14).

(5) Long-range market planning costs (FAR 31.205-12).

b. FAR 31.205-38(b) states that costs of activities which are correctly classified and disallowed under the above cost principles are not to be considered as allowable costs under FAR 31.205-38 or any other subsection of FAR 31.205.

7-1303.2 Illustrations of Improper Classification

The following illustrations represent the use of other FAR 31.205 subsections in reviewing a contractor's claimed selling costs for proper classification:

a. A contractor incurred engineering costs incident to adapting a system currently being produced for the government on one program for possible use on another major weapon system. The engineering effort was related to reducing the weight of the current system so it would be suitable for use on the other program. The effort performed included (1) development of a new cooling concept; (2) development of a new mechanical configuration and installation concept; (3) installation analysis of electrical power requirements; and (4) evaluation of reliability predictions and maintainability considerations. The contractor classified and claimed these costs as selling expense. Since the nature of the effort was "development," the costs should have been classified as independent research and development expenses and the criteria contained in FAR 31.205-18 applied. The effort of technical personnel can

properly be classified as selling costs only when they are functioning in a marketing role. Selling does not include generating the technology which the contractor is trying to market. Due to the government's exposure to risk in this area, technical effort charged to selling expense should be closely monitored and reviewed for proper classification.

b. A contractor incurred costs of promotional material, motion pictures, videotapes, brochures, handouts, magazines and other media that were designed to call favorable attention to the contractor and its activities. FAR 31.205-38(b) prohibits the contractor from claiming these costs as selling expenses, since FAR 31.205-1(f)(5) specifically disallows such costs as unallowable advertising or public relations costs.

7-1303.3 Audit Techniques to Identify Improperly Classified Selling Cost

The audit techniques and procedures necessary to determine whether a contractor has properly classified selling effort may include:

a. Floor checks and interviews of contractor personnel.

b. A review of documentary evidence establishing the purpose of the effort. This may include work order authorizations, expenditure authorizations, management reports, and board of directors' minutes.

c. An examination of correspondence with selling agents to ascertain the true nature of the activities and evidence of disputes over amounts of fees and commissions due.

d. Technical assistance which may be useful in determining the proper classification of selling effort.

7-1304 Allocability of Selling Costs

7-1304.1 General Allocability Considerations

a. FAR 31.201-4 and 31.203 contain criteria regarding the allocability of costs to cost objectives. These sections also apply to the determination of the allocability of selling costs. Proper allocability is accomplished by (1) the direct charge or (2) apportionment to particular cost objectives such as products, product lines or individual contracts, by means of a basis that will apportion the expenses in accordance with the benefits derived by the particular cost objectives, or the purposes for which the expenses were incurred. Also see 6-606 regarding allocability.

b. FAR 31.202(a) and 31.203(a) require, for costs incurred for the same purpose in like circumstances, consistency in the allocation of these costs as direct or indirect costs. Where a specific type or category of selling expense is allocated as a direct charge to government contracts or other cost objectives, care must be exercised to assure that all items or transactions in the same type or category applicable to other cost objectives are likewise allocated as a direct charge.

c. FAR 31.203(b) addresses selection of appropriate bases for allocation of indirect costs. The selection of an appropriate base for the apportionment of selling expenses as an indirect charge involves certain considerations different from those applicable to manufacturing expenses. Manufacturing expenses are usually apportioned without regard to the specific end item being manufactured or the customer to whom the item may ultimately be sold. These latter factors, however, are important considerations in apportioning selling expenses which may indicate that an over-all allocation of selling expenses on the basis of cost of sales or cost of goods manufactured may not be equitable. The auditor should perform a careful analysis of the time, effort, and expense incurred for selling activities in relation to the company's products, product lines or other objectives to determine the most suitable base for apportioning selling expenses.

d. When a contractor, with contracts subject to the Cost Accounting Standards, includes selling costs in its G&A pool, those costs are subject to the provisions of CAS 410.40(d) and 410.50(b)(1). CAS 410 does not provide guidelines on how foreign selling cost should be allocated, but instead takes a permissive position. These sections require that marketing costs, whose beneficial or causal relationship to business unit cost objectives can best be measured by a base other than a cost input base represent-

ing the total activity of a period, be removed from the G&A expense pool and allocated on a representative base. If a total cost input or value-added base is used to distribute G&A expenses, selling costs would then become part of the G&A allocation base. See also 8-410.

7-1304.2 Special Considerations for Allocability of Selling Costs

a. Selling agents' fees and commissions will usually be charged direct to contracts since, in most cases, independent agents are used and paid for individual sales transactions. However, where an agent is paid a retainer, fees may be charged indirectly. Where fixed retainer fees are paid to agents representing the contractor in specific geographical areas, they should normally be allocated to all applicable sales in these areas.

b. A review of past activities of the sales agents or selling agencies as they relate to the contractor's products or services may be useful in identifying causal or beneficial relationships of the agents' or agencies' services to the final cost objectives. A review of any agreements between sales agents and the contractor may also prove useful in verifying allocability.

7-1305 Reasonableness of Selling Cost

Reasonableness involves consideration of (1) the nature and amount of these costs in light of the expenses which a prudent individual would incur in the conduct of competitive business, (2) the proportionate amounts expended by government and commercial business, (3) the trend and comparability of the company's current period costs in relation to prior periods, (4) the general level of such costs within the industry, and (5) the nature and extent of the sales effort in relation to the selling costs and to the contract value. The foregoing considerations may result in a determination that a particular item or category of selling expense is not reasonable either in total due to its nature or in part due to the excessiveness of the amount involved (see FAR 31.201-3). In determining reasonableness, the following factors should receive special consideration:

a. Some companies engaged in defense production expend substantial amounts to establish and maintain large staffs of salesmen and engineers whose primary function is obtaining new or additional government business on a prime or subcontract basis for existing company products and to seek out other products required by the government which the company can manufacture with its existing facilities. The submission of unsolicited bids and proposals and the preparation of brochures setting forth the company's capabilities and past accomplishments with respect to defense work usually represent an important aspect of this function. In periods of low volume, companies may divert normal production engineering personnel to augment their sales staff on a temporary basis or hire additional sales personnel to increase volume.

b. If appropriate safeguards are not maintained with respect to selling expenses, companies engaged wholly or substantially in government production under flexibly priced contracts may conceivably be encouraged to increase their selling activities without restraint since they would expect to be compensated therefor as a necessary cost of doing business. Other companies in the same industry with little or no existing flexibly priced government business (cost-type or price-redeterminable contracts) would thus be placed in an unfavorable competitive position for new government business as compared with those companies who in effect have been subsidized by the government for their selling activities.

c. Each audit should also include an appraisal of the extent to which the sales promotion, consultation, technical, liaison and other related activities engaged in by the contractor's personnel produced a recognizable benefit to the government in consonance with the amounts included in the contractor's claims or cost representations. "Benefit to the government" should be considered, in a broad sense, as the acceptability of selling expense is not necessarily contingent upon a showing of proof that the performance of a specific item would not have been possible without the incurrence of such expenses. If it can be established that useful and desirable infor-

mation was exchanged or that technical matters concerning existing contracts were discussed during visits by the contractor's personnel to government procurement offices, the resulting costs may be considered to result in "benefit to the government." This situation is contrasted with visits made for purely promotional purposes where a contractor's sales representative seeks government contracts or related information and his or her visits do not result in any commensurate benefit to the government.

7-1306 Allowability of Selling Cost

7-1306.1 Introduction

Several types of selling costs are expressly unallowable per FAR 31.205-38 and other subsections of the FAR and DFARS. FAR 31.201-6 and CAS 405 (see 8-405), require contractors to identify and exclude any expressly unallowable costs, including directly associated costs, from any billing, claim, or proposal applicable to a government contract. FAR 31.205-38(b) states that costs that have been made expressly unallowable by other subsections of FAR 31.205 shall not be allowable as selling costs under 31.205-38 (see 7-1303). Auditors should screen selling costs to ensure that contractors have properly identified and segregated the expressly unallowable costs discussed in the sections that follow.

7-1306.2 Foreign Selling Costs

a. Direct selling costs incurred in connection with potential and actual Foreign Military Sales, as defined by the Arms Export Control Act, or foreign sales of military products or services have been specifically allowable or unallowable on U.S. government contracts for U.S. government requirements depending on the date of the contract or when the costs were incurred and the issuing agency.

b. The following chronology shows the regulatory history of foreign selling costs (see 7-1202.2g):

(1) 1/20/86 - 5/15/91

Foreign selling costs were unallowable on U.S. government contracts for its own requirements. (FAR 31.205-38(f))

(2) 4/12/88 - 12/15/88

Costs of "significant effort" to export American aerospace products were made allowable in the FAR as an exception to the normal rule on foreign selling costs. (FAR 31.205-1(g)) Other foreign selling costs remained unallowable. (FAR 31.205-38(f))

(3) 12/15/88 - 5/15/91

Effective December 15, 1988, the DAR Council issued new DFARS cost principle coverage for foreign selling costs to implement the requirements of Section 826 of the Defense Authorization Act for FY 1989 (P.L. 100-456). Costs of "significant effort" to export U.S. defense industry products were made allowable (as an exception to the FAR rule) for DoD contracts, subject to a ceiling of 110% of the prior year's costs for those business segments allocating $2,500,000 or more of such costs to DoD contracts. (DFARS 231.205-1 & 231.205-38) The allowability of costs for all other business segments was subject to the usual reasonableness criteria. The FAR rules were unchanged.

(4) 5/15/91 - 5/15/97

Effective May 15, 1991, the DFARS coverage was moved to the FAR, thereby applying the rule to all U.S. government contracts. Costs of "significant effort" to export products normally sold to the U.S. government were allowable for all U.S. government contracts, subject to a ceiling of 110% of the prior year's costs (for those business segments allocating $2,500,000 or more of such costs to U.S. government contracts) and the allocability, reasonableness, and allowability tests otherwise applicable to such costs. (FAR 31.205-1(d)(2) & 31.205-38(c)(2)).

(5) 5/16/97 - Current

Effective May 16, 1997, FAR 31.205-38(c)(2) was revised to remove the $2.5 million threshold and the 110% ceiling on allowable foreign selling costs. Costs of "significant effort" to export products normally sold to the U.S. government are allowable for all U.S. government contracts subject to the allocability, reasonableness, and allowability tests otherwise applicable to such costs. (FAR 31.205-1(d)(2)). See guidance in 7-1304, 1305, and 1306.1 for discussions on allocability, reasonableness, and allowability of selling costs.

7-1306.3 Sellers' or Agents' Compensation, Fees, Commissions, etc.

a. FAR 31.205-38(f) makes unallowable sellers' or agents' compensation, fees, commissions, percentages, retainer, or brokerage fees, whether or not contingent upon the award of contracts, except when paid to bona fide employees or established commercial or selling agencies maintained by the contractor. DFARS 225.7303-4 extends this guidance to FMS contracts (see 7-1307). The following guidance is applicable to the review of sales agents' fees and commissions:

(1) Business firms sometimes hire an independent organization or individual to conduct business on their behalf. Often this is done for foreign locations where it would be too difficult and/or expensive to open and maintain a regular place of business. An organization or individual hired for this purpose is known as an "agent" of the employing firm. If hired specifically to make sales for the firm, the person or organization is known as a sales agent and is usually paid a fee or commission calculated on some percentage of his sales.

(2) Agents' fees are normally not encountered in domestic DoD contracts. They are usually included in foreign military contracts and may be paid under either of two forms of foreign procurements: (a) the foreign government may buy direct from a U.S. contractor or (b) it may use DoD's procurement resources to buy items commonly referred to as foreign military sales (FMS). In either case, if agents are involved in arranging the sales, their fees should be identified in contractors' proposals. See 7-1307 regarding FMS contracts.

(3) FAR 3.402 states that contingent fees for soliciting or obtaining government contracts are considered contrary to public policy because such arrangements may lead to attempted or actual exercise of improper influence. However, an exception is provided for contingent compensation arrangements with bona fide employees or bona fide agencies (FAR 3.402(b) & FAR 31.205-38 (f)). As defined in FAR 3.401, a bona fide employee or bona fide agency neither exerts nor proposes to exert improper influence to solicit or obtain government contracts, nor holds out as being able to obtain any government contract or contracts through improper influence.

b. Payments of commissions, fees, or compensation of any kind by, or on behalf of, a subcontractor to any officer, partner, employee, or agent of a prime contractor or upper-tier subcontractor as an inducement for, or acknowledgment of, a subcontract award under any negotiated contract with the government are prohibited by the Anti-Kickback Statute. When the auditor discovers that such fees or commissions have been paid, the procedures in 4-704 should be followed.

7-1307 Selling Costs Under Foreign Military Sales (FMS) Contracts

7-1307.1 General Requirements

The basic procurement policy for pricing FMS contracts is in DFARS 225.7303. These regulations supplement those policies contained in FAR Part 31 and FAR Subpart 3.4.

7-1307.2 Definition of Foreign Military Sales (FMS)

The Arms Export Control Act (formerly known as the Foreign Military Sales Act of 1968) defines FMS as sales of defense articles and services to foreign governments. Although it is DoD policy to encourage the purchase of defense articles and services directly from U.S. sources, most of them are purchased through established DoD procurement and contract administration channels because many kinds of defense transactions are not conducive to direct sales. These include transactions that require government-to-government arrangements, such as sales of classified equipment, items produced in U.S. arsenals, major weapon systems, and sales in situations where the U.S. government wants to exercise special control. Additionally, foreign governments usually want the advantages of DoD's procurement expertise, including contract administration and audit. Thus, FMS only encompasses government-to-government transactions as defined by the DoD Security Assistance Management Manual (DoD 5105.38-M).

7-1307.3 Audit Considerations

a. DFARS 225.7301(b) requires that acquisitions for FMS contracts be conducted under the same acquisition and contract management procedures as other defense contracts. DFARS 225.7303(a) states that foreign military sale contracts are to be priced using the same principles as are used in pricing other defense contracts. However, application of the principles contained in FAR Part 15 and FAR Part 31 may result in prices that differ from other defense contract prices for the same item. Therefore, DFARS 225.7301(c) requires known FMS requirements to be separately identified in solicitations.

b. DFARS 225.7303-2(a) provides for the recognition of, under FMS contracts, the costs of doing business with a foreign government or international organization.

c. According to DFARS 225.7303-2(c), the cost limitations for major contractors on bid and proposal (B&P) costs and on independent research and development (IR&D) costs for projects that are of potential interest to DoD, in DFARS Part 231.205-18(c)(iii), do not apply to FMS contracts, except as provided in DFARS 225.7303-5; i.e., for acquisitions wholly paid for from nonrepayable funds. IR&D and B&P costs allowed on FMS contracts, not wholly paid for from funds made available on a nonrepayable basis, shall be limited to the contract's allocable share of the contractor's total IR&D/B&P expenditures. In pricing FMS contracts, use the best estimate of reasonable costs in forward pricing. Use actual expenditures to the extent that they are reasonable, in determining final cost.

d. Costs of sales agents' commissions or fees under FMS contracts are subject to the allowability criteria as specified in FAR 31.205-38(f) (see 7-1306.3). However, DFARS 225.7303-4 provides additional guidelines on the allowability of contingent fees under FMS purchases. The following guidance is relevant when reviewing the acceptability of contingent fees under FMS contracts:

(1) As specified in FAR 31.205-38 (f), the commissions and fees are allowable only if paid to a bona fide employee or a bona fide established commercial or selling agency. DFARS 225.7303-4(a) also requires that the contracting office determine that contingent fees are fair and reasonable.

(2) The auditor should request from the contractor documents or other information bearing on the allowability and reasonableness of the agent's commissions or fees.

(3) Commissions and other items of cost such as taxes and miscellaneous fees, unique to each country, must be handled on an individual basis in evaluating the overall reasonableness of the agent's fees. These costs should be brought to the contracting officer's attention through coordination and reporting.

(4) DFARS 225.7303-4(b)(1) provides a listing of countries that have prohibited the payment of sales commissions or fees, unless such payments have been identified and approved in writing by the government involved prior to contract award. For FMS to countries not included in the listing, DFARS 225.7303-4(b)(2) specifies that contingent fees exceeding $50,000 per FMS case are unallowable under DoD contracts, unless payment has been identified and approved in writing by the foreign customer before contract award.

e. DFARS 225.7303-5 states that sales to foreign governments wholly paid for from funds made available on a nonrepayable basis shall be priced like domestic DoD acquisitions in regard to profit, overhead, IR&D/B&P and other costing elements. The determination of whether the funds are nonrepayable can be made from the Letter of Offer and Acceptance (LOA) between the U.S. government and the government of the foreign country, which the contracting officer can provide. Nonrepayable funds, made available through Congressional appropriations under Foreign Military Financing programs, are similar to grant aid, which the foreign government must spend on defense products of U.S. contractors.

7-1307.4 Foreign Military Sales (FMS) Offset Arrangements

a. The purpose of an FMS offset arrangement is to fulfill commitments negotiated pursuant to an FMS agreement. The general policy in fulfilling these commit-

ments is to exempt the FMS country's products from the requirements of the Buy American Act on a case-by-case basis. DFARS 225.7307 contains additional information on the implementation of offset arrangements.

b. DFARS 225.7303-2(a)(3) permits defense contractors to recover costs incurred to implement their offset agreements with a foreign government or international organization if the LOA is financed wholly with customer cash or repayable foreign military finance credits. Since the U.S. government assumes no obligation to satisfy or administer the offset requirement or to bear any of the associated costs, auditors should be sure that these costs are charged direct to the contract and not charged to indirect expense pools and allocated to domestic government business. Charges to domestic government contracts should be questioned if claimed by the contractor. In addition, a U.S. defense contractor may not recover costs incurred to implement its offset agreement with a foreign government or international organization if the foreign military sale is financed with funds made available on a nonrepayable basis. Auditors should be sure these costs are not recovered directly on the contract or charged to indirect expense pools (DFARS 225.7303-5(c)).

7-1400 Section 14 --- Taxes

7-1401 Introduction

This section provides general guidance in reviewing the allocability and allowability of taxes, including Federal, state, and local taxes; employment taxes; employment taxes of successor contractors following mergers or consolidations; Federal excise taxes; foreign taxes; and environmental taxes.

7-1402 Expressly Unallowable Taxes

FAR 31.205-41(b) states that the following types of taxes are expressly unallowable as costs under government contracts:

a. Federal income and excess profits taxes.

b. Taxes in connection with financing, refinancing, or refunding of operations, or reorganizations (See also FAR 31.205-20 and 31.205-27).

c. Taxes from which exemptions are available to the contractor directly, or available to the contractor based on an exemption afforded the government, except when the contracting officer determines that the administrative burden of obtaining the exemption outweighs the benefits accruing to the government (See FAR Part 29).

d. Special assessments on land that represent capital improvements.

e. Taxes (including excises) on real or personal property, or on the value, use, possession or sale thereof, which is used solely in connection with work other than on government contracts (See also 7-1403.1a below).

f. Taxes on accumulated funding deficiencies of, or prohibited transactions involving, employee deferred compensation plans pursuant to Section 4971 or Section 4975 of the Internal Revenue Code of 1986, as amended.

g. Income tax accruals designed to account for the tax effects of differences between taxable income and pretax income as reflected by the books of account and financial statements (See also 7-1403.4a below).

7-1403 State and Local Taxes

State and local taxes, including property, franchise, and income taxes, are allowable contract costs in accordance with FAR 31.205-41. However, if the taxes are paid late or in error, any penalty, or interest on borrowings (see 7-1403.1(e)), assessed by the state or local government is an unallowable cost except in the limited circumstances described in FAR 31.205-41(a)(3).

7-1403.1 General Audit Considerations

a. Care must be exercised regarding the propriety of allocation of certain taxes to government work. For example, the allocation to all work of the contractor of personal property taxes levied against the contractor's commercial inventories may not be proper where similar taxes are not levied against government contract inventories.

b. FAR 31.205-41(b)(5) states that taxes (including excises) on real or personal property, or on the value, use, possession, or sale thereof, which is used solely in connection with work other than on government contracts are not allowable. FAR 31.205-41(c) states that these taxes should be allocated to the respective category of work unless the amounts involved are insignificant or comparable results would otherwise be obtained. The costs of taxes incurred on property used in both government and non-government work shall be apportioned to all such work based upon the use of such property on the respective final cost objectives.

c. If the contractor claims taxes for which there exists a question of illegal or erroneous assessment, the amount of such taxes should be identified and described in advisory audit reports and contract audit closing statements. If it is subsequently determined that the taxes have been improperly assessed, a credit or refund may be pursued by the government (See FAR 31.205-41(a)(2)).

(1) The auditor should follow up as appropriate to assure that a proper share of credits or refunds received by the contractor is passed on to the government (See FAR 31.205-41(d)).

(2) If the contractor has failed to take actions as specified in FAR 31.205-41(a)(2), the costs should be questioned or disapproved.

d. Penalties assessed by state or local tax authorities are unallowable in accordance with FAR 31.205-15 even if they are unavoidable or incurred inadvertently. However, FAR 31.205-41(a)(3) provides a specific exception to the disallowance of penalties when incurred as a result of following the contracting officer's direction or permission not to pay taxes assessed by a state or local government.

e. Generally, interest associated with an intentional underpayment of state or local taxes is unallowable per FAR 31.205-20 because the interest can be considered to be "interest on borrowings." "Intentional," as used here, means intentionally paying less than the contractor reasonably believes is due. However, interest associated with an underpayment of taxes, where the contractor's intent to borrow cannot be shown, is allowable. If the contractor's underpayment was directed or agreed-to by the contracting officer, FAR 31.205-41(a)(3) allows any resulting interest.

f. Interest incurred as a result of late payments (e.g., not paying financial obligations by the due date) represents "interest on borrowings" and is therefore unallowable per FAR 31.205-20.

7-1403.2 Allocation Problems and Methods

a. State income or franchise taxes sometimes present unique allocation problems. From a taxing standpoint, when a corporation is engaged in activities in several states it becomes necessary to determine the share of a corporation's income to be attributed to each state. The states have developed three primary methods of dividing the income of a multi-state taxpayer: separate accounting, specific allocation, and formula apportionment. Each method is discussed below.

(1) Separate Accounting. The separate accounting method is based on the premise that a multi-state taxpayer can be divided into separate entities so that its activities within the taxing state can be segregated from its activities elsewhere and accounted for separately. This method is seldom acceptable to the states.

(2) Specific Allocation. The specific allocation method provides for the designation of specified items of income in their entirety as either within or outside the state. This method is infrequently used by itself, but is often combined with the formula apportionment method discussed below.

(3) Formula Apportionment. This is the most frequently used method. The percentage of income to be assigned to a particular state is determined by averaging a number of ratios. For example, one ratio frequently used is the ratio of in-state sales to out-of-state sales. Similar ratios are commonly based on property and on payroll. The average of the ratios used is then multiplied by the net income subject to apportionment (defined by the state) to arrive at the taxable income for the state.

b. Through the use of the method described in a.(3) above, it is possible that a multi-state taxpayer may be assessed a large corporate state income or franchise tax by a particular state and in actuality have very little income recorded on the books of its operations within that state. Apportionment of unitary income in excess of local book income within the state is justified by courts on the assumption that all component activities, wherever located, contribute proportionately to all corporate income.

c. Contractors often include the above discussed taxes, along with other indirect expenses, in an established burden center for allocation to operating divisions located in various states. In reviewing these allocations, the general rule for the auditor to follow is to determine that the amount allocated to operations within a particular state approximates the amount of tax paid to such state. The further allocation of this amount to cost centers or contracts within the state should be made through divisional G&A. However, in those cases where a division is doing business in several states, the auditor may find that more equitable results are obtained by applying the method used by the state in assessing the tax, or through an established burden center of the contractor other than G&A. The following

guidance relates to the allocation of state franchise taxes to a company's segments:

(1) CAS 403.40(b)(4) requires that central payments or accruals (which may include state and local income taxes and franchise taxes) made by a home office on behalf of its segments shall be allocated directly to segments to the extent that all such payments or accruals of a given type or class can be identified specifically with individual segments. Any such types of payments or accruals which cannot be identified specifically with individual segments shall be allocated to benefited segments using an allocation base representative of the factors on which the total payment is based. (Also see 8-403.)

(2) Lockheed Corp. and Lockheed Missiles & Space Co., ASBCA Case No. 27921, 86-1 BCA ¶ 18,614, aff'd, 817 F.2d 1565 (Fed. Cir. 1987) and U.S. Court of Appeals for the Federal Circuit Case No. 86-1177 contain extensive and detailed discussions of the allocation of state franchise taxes to segments. In the ASBCA case, the Board ruled that Interpretation No. 1 to CAS 403 is not binding as to the meaning of CAS 403 because the promulgation of the Interpretation did not follow the statutory requirements for issuance of a standard and that a segment's income (or loss) was an appropriate factor to consider in the allocation of state franchise taxes to segments. The ASBCA decision was upheld by the Court. However, in rendering its decision, the Court's rationale departed somewhat from that of the ASBCA. It did not believe the validity of Interpretation No. 1 was relevant to its decision. The decision effectively relegated Interpretation No. 1 to the status of elaborating upon the CAS 403.60(b) illustration concerning taxes. The Court ruled that the one example in CAS 403.60(b) did not defeat the plain meaning of "factors" as used at CAS 403.40(b)(4). Since segment net income is a causal factor, the Court ruled that CAS 403.40(b)(4) permitted it in an allocation formula. In the Claims Court case No. 49-89C. Hercules, Inc. v. U.S., 26 Cl.Ct. 662 (1992), the Court re-emphasized that net income is permitted, but not required, as an allocation factor.

(3) The Court's ruling does not mean that all allocation methods that use segment book income are automatically compliant. In fact, the Court only held that Lockheed's two-step, four-factor formula complied with CAS 403.40(b)(4), because the parties had stipulated that if CAS 403 permitted net income as an allocation factor, then the Lockheed method complied with CAS 403. In the ASBCA case that was the subject of the appeal, two other allocation methods that used income as an allocation factor were considered and rejected. The Lockheed method which the Court ruled is compliant and the two methods using income (the Factor Analysis, and Proration Percentage) that the ASBCA held were noncompliant are described and illustrated at 7-1403.3.

d. Allowing income as an allocation factor broadens the choices of possible allocation methods and makes the evaluation of tax allocations more difficult. Each situation must be carefully evaluated to determine if the particular methodology makes appropriate use of segment book income. The following two key areas deserve special attention when evaluating any methodology which uses segment book income:

(1) The first is evaluating the contractor's methodology for determining the propriety of segment book income. For tax purposes, most states do not use segment book income as a unitary income apportionment factor because of concerns that companies could easily manipulate segments' books to show income only at segments that are in low-tax or no-tax jurisdictions. This risk of income manipulation is why most states choose not to accept the taxpayer's identification of segment income. Because proper identification of income is a high-risk area, the auditor should carefully assess a contractor's determination of segment book income to ensure the methodology is sound and consistently applied.

(2) The second is ensuring that taxes are confined to segments doing business in the taxing jurisdiction. This issue was dealt with in the Claims Court case No. 49-89C. Hercules, Inc. v. U.S., 26 Cl.Ct. 662 (1992). The Court ruled that a contractor is not in full compliance with CAS 403 if the taxes of a jurisdiction are not allocated to only those segments that do business in the taxing jurisdiction.

7-1403.3 Illustrations of Allocation Methods That Use Income as an Allocation Factor

The illustrations below supplement the guidance in 7-1403.2 and are intended to be used as a guide when evaluating allocation methods that use segment book income. The following facts will be used for all three illustrations:

a. A company has a California Franchise Tax expense of $11,000,000 and five segments --- A, B, C, D, and E with property, payroll, and sales of:

			SEGMENTS			
	A	B	C	D	E	TOTAL
			(in millions)			
PROPERTY:						
Total	$1,500	$ 800	$ 600	$ 400	$ 200	$3,500
Calif.	750	720	600	100	20	2,190
Calif. %	50%	90%	100%	25%	10%	62.6%
PAYROLL:						
Total	$ 700	$ 300	$ 250	$ 100	$ 80	$1,430
Calif.	280	240	250	30	8	808
Calif. %	40%	80%	100%	30%	10%	56.5%
SALES:						
Total	$2,000	$1,000	$ 800	$ 600	$ 300	$4,700
Calif.	600	800	760	240	45	2,445
Calif. %	30%	80%	95%	40%	15%	52%
AVG CALIF. %	40%	83.3%	98.3%	31.7%	11.7%	57%

The five segments had the following net income (loss):

	(in millions)
Segment A	$(200)
Segment B	125
Segment C	180
Segment D	90
Segment E	20
Total Net Income	$ 215

b. Lockheed Two-Step, Four-Factor Method: The ASBCA and the Federal Circuit Court held that Lockheed's two-step, four-factor formula complied with CAS 403.40(b)(4). The first step entails calculating each segment's net income derived from or attributable to a particular state's sources (e.g., California sources) using the ratio of in-state property, payroll, and sales, to total property, payroll, and sales for the segment. In the second step, Lockheed totals individual segment net income derived from or attributable to profitable in-state sources and then assigns taxes only to each profitable segment in the proportion that the segment's profits bear to total profits. Segments with no net income get no allocation and segments that do get allocations get them based upon relative profitability.

STEP 1:

	(in millions)				
	Segment net income (loss)		Segment apportionment %		Segment net income from Calif. sources
Segment A	$(200)	X	40%	=	$0*
Segment B	125		83.3%		104
Segment C	180		98.3%		177
Segment D	90		31.7%		29
Segment E	20		11.7%		2
					$312
*Note: Credits are not permitted, therefore segments with losses always are assigned $0 income.					

STEP 2:

	(in millions)				
	Total Tax		Segment Contribution		Allocation
Segment A	$11	X	0	=	$0
Segment B	11		104/312		3.67
Segment C	11		177/312		6.24
Segment D	11		29/312		1.02
Segment E	11		2/312		.07
					$11.00

c. Factor Analysis Method: In the first Lockheed Corp. and Lockheed Missile & Space Co., ASBCA case (No. 22451, 80-1 BCA para. 14,222), the ASBCA considered and rejected an allocation method that used income entitled the "Factor Analysis Method." Under this method a segment's share of total California Franchise Tax liability is calculated by first determining the percentage that the segment's net income is of the total net income (segment net losses result in negative percentage). A second percentage is calculated by averaging the ratio of the segment's California property, payroll, and sales to the total California property, payroll, and sales. Next the two percentages are averaged by adding them together and dividing by two. The resulting percentage is then multiplied by the total California Franchise Tax expense to obtain the amount of tax or credit allocated to the segment.

The ASBCA concluded that the Factor Analysis Method did not comply with CAS 403 because it allows credits for loss segments. Including credits for losses yielded allocations in excess of the actual amount actually paid. Following is an illustration of this method:

STEP 1:

	(in millions)	
Segment net income as % of total income (loss)	Segment Calif. property, payroll, and sales as % of total Calif. property, payroll, and sales	
	Property Payroll Sales	
A (200/215 or (93%)	750/2190 = 34% + 280/808 = 35% + 600/2445 = 25% / 3	or 31%
B 125/215 or 58%	720/2190 = 33% + 240/808 = 30% + 800/2445 = 33% / 3	or 32%
C 180/215 or 84%	600/2190 = 27% + 250/808 = 31% + 760/2445 = 31% / 3	or 30%
D 90/215 or 42%	100/2190 = 5% + 30/808 = 4% + 240/2445 = 10% / 3	or 6%
E 20/215 or 9%	20/2190 = 1% + 8/808 = 1% + 45/2445 = 2% / 3	or 1%

STEP 2:

	Sum of two% divided by 2		Total Tax		Allocation (Credit)
Segment A	[(93%) + 31%]/2 = (31%)	X	$11	=	$(3.41)
Segment B	[58% + 32%]/2 = 45%		11		4.95
Segment C	[84% + 30%]/2 = 57%		11		6.27
Segment D	[42% + 6%]/2 = 24%		11		2.64
Segment E	[9% + 1%]/2 = 5%		11		.55
					$11.00

Note: Together, segments B, C, D, and E are allocated $3,410,000 more in tax expense than the total California Franchise Tax liability.

d. Proration Percentage Method: In the first Lockheed Corp. and Lockheed Missile & Space Co., ASBCA case (No. 22451, 80-1 BCA para. 14,222), the ASBCA also considered and rejected a second allocation method that used income. This one was called the Proration Percentage Method. Under this method a segment's share of the state tax liability is calculated by multiplying the segment's net income or net loss by the ratio of in-state property, payroll, and sales, to total property, payroll, and sales. The product is then multiplied by the state tax rate to yield the amount of tax or credit allocated to the segment.

The ASBCA rejected the Proration Percentage Method because it in effect allocates only on the basis of profit and loss. In other words, there is no consideration of each segment's apportionment factors. Moreover, this method also included credits for losses and would result in allocations to profitable segments in excess of actual taxes paid. Following is an illustration of this method:

	(in millions)							
	Segment net income (loss)		Calif. Apportionment %		Calif. Franchise Tax Rate			Allocation (credit)
Segment A	[$ (200)	X	57%]	X	9%		=	$(10.2)
Segment B	[125		57%]		9%			6.4
Segment C	[180		57%]		9%			9.2
Segment D	[90		57%]		9%			4.6
Segment E	[20		57%]		9%			1.0
								$11.0

7-1403.4 Guidance in Determining Allowable State and Local Taxes

a. Tax Accruals

(1) Provisions are sometimes made by contractors to account for estimated state income or franchise taxes when there are significant differences between taxable income, as determined in accordance with state regulations, and income for the period, as determined in accordance with generally accepted accounting principles. These differences may result from items such as (a) recognizing in the income statement possible losses that may not be deductible for tax purposes until they occur, (b) computing depreciation for income statement purposes by use of a method different from that used for tax purposes, or (c) by recognizing revenue for tax purposes before it would be recognized in the income statement in accordance with generally accepted government accounting principles. Provisions are made for taxes related to such items based on an assumption that a tax liability exists, and will ultimately materialize, as a direct result of such transactions. For example, in the case of a straight line method of depreciation being used for income statement purposes and an accelerated method for tax purposes, the tax savings in the early years of the asset's life will ultimately be offset by higher taxes in the later years of the asset's life. Therefore, the provisioning of an additional amount for taxes in the early years of the asset's life to offset the higher taxes in the later years in effect tends to relate the state income tax expense for the period to the income as shown in the financial statements. The opposing view contends that if a contractor follows a consistent program of asset replacement, which would be necessary to a continuing concern, tax savings on new assets should offset higher taxes on expiring assets.

(2) The auditor is concerned with the best evidence available which supports the amount of costs incurred. In determining allowable costs under government contracts, the best evidence available to support the amount of state income or franchise tax incurred is the amount paid. The auditor should not attempt to estimate the amount of tax currently being paid, but applicable to future or prior periods, for purposes of determining allowable costs under government contracts. Similarly, amounts estimated by contractors as tax liabilities in excess of the amounts actually paid should not be considered in determining allowable contract costs. Income tax accruals designed to account for the tax effects of differences between taxable income and pretax income as reflected by the books of account and financial statements are unallowable (See FAR 31.205-41(b)(7)).

(3) Income tax accruals designed to estimate additional taxes to be paid resulting from tax audits by the state or local tax authorities are considered contingencies that are unallowable within the purview of FAR 31.205-7(b). However, tax accruals designed to relate the amount paid on the basis of a taxing authority's fiscal year to the contractor's accounting period are allowable in accordance with FAR 31.205-41(a). (See also 7-1402.g.)

b. Tax Credits and Refunds

(1) Many states follow the same or basically similar procedures as provided in the Internal Revenue Code for net operating loss carry-backs. In most states a net operating loss can be carried back for 3 years or forward for 5 years. We are primarily concerned with carry-backs for state income or franchise taxes. Operating loss carry-backs

will result in a refund of prior years' taxes which have been paid by the contractor and reimbursed by the government.

(2) The government's right to share in these refunds is covered by FAR 31.205-41(d), which provides that "Any taxes, interest, or penalties that were allowed as contract costs and are refunded to the contractor shall be credited or paid to the government in the manner it directs." This requirement is also addressed in FAR 31.201-5 and the "Allowable Cost and Payment" clause at FAR 52.216-7. Where the amount is material, equity dictates that the tax refund be allocated to the government customers in the same ratio as they were originally charged with the tax payment.

7-1403.5 Changes in Method of Measuring Taxable Income

a. State tax regulations have usually permitted a taxpayer to initially select one of several acceptable methods of stating the elements that determine taxable income and later, under specified conditions, to change from the initial selection to another acceptable method. Some elements for which alternate acceptable methods have been allowed are (1) income from long-term contracts, (2) inventory pricing, and (3) depreciation methods.

b. The Tax Reform Act of 1986 (TRA) repealed the acceptability of the completed contract method for measuring annual taxable income for long term contracts awarded after February 26, 1986. Since the TRA, the IRS has implemented additional restrictions on methods that can be used to measure annual taxable income. Although the changes in method are intended primarily to apply to Federal income taxes which are not allowable on government contracts under FAR 31.205-41(b)(1), State income taxes, which are allowable on government contracts, will in many cases also be affected since a number of States have adopted Federal tax regulations to determine State taxes.

c. Under the provisions of the change, contractors must recognize income from long term contracts using either the percentage of completion method or the percentage of completion-capitalized cost method. Both methods must be based on a cost-to-cost relationship rather than an estimate of physical completion (engineering cost method or other modified methods not based on cost) which was previously permitted. The percentage of completion method based on a cost-to-cost relationship recognizes income from long term contracts based on the proportion of the estimated contract price that costs incurred through a period bears to the total expected costs reduced by the amounts of contract price that were included in income in previous years. Under the percentage of completion-capitalized cost method, only a certain percent of the items of each contract need to be recognized under the percentage of completion method and the remaining percent of the items are to be accounted for under the taxpayer's normal method (e.g., the completed contract method). Costs to be used in determining the percentage of completion are: (1) direct material and direct labor costs, and (2) depreciation, amortization and cost recovery allowances on equipment and facilities directly used to construct or produce the subject matter of the contract. It should be noted that the prescribed cost-to-cost relationship is an example of circumstances where the tax law is at variance with appropriate cost accounting.

d. Any changes made in the method of measuring income for long term contracts as a result of changes in tax regulations (e.g., a change from the completed contract method to the percentage of completion method or the percentage of completion-capitalized method) should be considered to be a change in cost accounting practice because it alters the measurement of State tax costs for a cost accounting period by assigning taxable income or loss to other periods. Because measurement and assignment of cost are involved, the change in determining contract income is a change in cost accounting practice as described in CAS. Since the change is not being required by any change in CASB rules, regulations and standards, it should be considered a unilateral change unless and until the cognizant Federal agency official (CFAO) determines that the change is desirable. (See CAS Working Group Paper 81-25.)

e. When a contractor is required by the tax laws to change its accounting practices, changing from a no longer acceptable method to an acceptable method may be considered a desirable change. However, a final determination on this matter is the responsibility of the CFAO. Unless the CFAO makes the determination that the change meets the requirement to be considered a desirable change (i.e., not detrimental to the interests of the government), the change would be considered a unilateral change covered by paragraph (a)(4)(iii) of the CAS clause (FAR 52.230-2) and no increased costs as a result of the change would be permitted (see also 8-303).

f. Auditors should also be aware that the TRA includes a look-back provision. This provides that, to the extent that the percentage of completion applies to a long term contract, a taxpayer who does not accurately predict the eventual contract price must recompute its tax liability for the years that such method was used on the basis of the actual contract price and costs. If the recomputed tax liability exceeds the previously reported tax liability, the taxpayer must pay interest; if the recomputed tax liability is less, the taxpayer is entitled to interest. This provision may affect State tax costs to the extent that this look-back provision is incorporated into State laws. Accordingly, auditors should review the look-back computations to determine if any unallowable penalties and interest are included in costs charged to government contracts or if the government is due a credit.

7-1403.6 Special Considerations--- Revenue Based State Taxes

a. Some state taxes (e.g., New Mexico and Washington) are imposed on the seller, and are computed by multiplying the total revenues (with limited exceptions) received from doing business in the state by the applicable tax rate. There is no legal obligation for the seller to collect the tax from the buyer. For the purpose of Federal immunity, this makes these state taxes different from conventional sales taxes.. If the tax is imposed on the seller and there is no legal obligation to collect the tax from the buyer, then the seller is not exempt from paying state sales taxes on sales to the government unless there is an express government sales exemption in the applicable tax code. However, normally the seller has a legal obligation to collect the tax from the buyer. When there is a legal obligation to collect the tax from the buyer, and the buyer is the government, the sales are exempt from state sales tax as a matter of federal supremacy. State law dictates whether the government is the buyer or not in transactions involving government contracts. For example, the Connecticut Supreme Court, applying Connecticut statutes, found that the United States is the actual buyer of personal property sold by third parties to a cost-reimbursement government contractor because the one who takes title to the property is the United States. It held such sales exempt from Connecticut sales tax. In contrast, services sold by third parties to government contractors were not exempt since a different statutory test applied and it identified the contractor as the buyer, not the government. Determinations of whether state and local taxes are allowable contract costs under FAR 31.205-41 must be made on a case-by-case basis based on each state's tax laws. Questions regarding state-law exemptions and federal sovereign immunity should be addressed to the contracting officer's designated legal counsel because they require interpretations of statutes, regulations, and case law (FAR 29.101).

b. Revenue based state taxes are levied on the contractor's revenue from doing business in the state, which generally comprises many contracts. Therefore, the costs incurred by the contractor are not identifiable to specific contracts. Accordingly, the state tax should be distributed to contracts using the contract revenue that is subject to the state tax as the allocation base.

c. Revenue based state taxes are overall costs of doing business in the nature of G&A expenses. However, these taxes, if material, should not be accounted for in the G&A pool. Any method of distributing material amounts of revenue based state taxes through overhead, G&A, or any other cost based allocation would be inappropriate, since the taxes are based on revenue rather than cost.

d. Revenue based state taxes should be included in the total cost input base for G&A allocation. Exclusion of these taxes through the use of a special allocation under CAS 410.50(j) is inappropriate, since such special allocations apply to final cost objectives, not specific cost elements.

7-1404 Employment Taxes

a. The Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) each impose a tax upon employers for each calendar year, the amount of which is based upon a specified percent of the wages paid by the employer to his individual employees. The taxes are limited to the annual maximum wages established by statute for each individual employee. These rates and wage limits vary periodically. The taxes imposed by the FUTA are levied and collectible in part by the state and in part by the Federal government. The guidance in this paragraph is concerned with the phase of these taxes levied on employers and not on employees.

b. Generally, if during a calendar year an employee receives remuneration from more than one employer, the annual wage limitation does not apply to the aggregate remuneration received from all employers, but instead applies to each individual employer. Exceptions to this rule are discussed below in 7-1405 and 7-1406.

c. The auditor should familiarize himself or herself with the rates and wage limitations in effect for each calendar year and ascertain that the contractor is not paying taxes in excess of the statutory requirements. He or she should also obtain supporting documentation for the various state unemployment rates being used by the contractor in those states in which it is paying the tax. Attention should also be given to tax credits or reductions granted the employer in state unemployment tax rates because of favorable employment experience. In such cases, the auditor should accept as allowable costs only the actual (net) amounts which the contractor is required to pay.

d. Where historical data are the basis for cost projections or estimates, consideration should be given to the effect that prospective changes in the tax rates and annual wage limitations will have on such forecasts. The auditor should assure that where expense accruals are made for these taxes they are adjusted periodically so that costs charged to contracts do not exceed the actual cost.

7-1405 Employment Taxes of Successor Contractors

a. Successor contractor situations generally relate to yearly service or maintenance contracts at government installations where, under recompetition, a new contractor receives a cost-reimbursement type contract award, usually cost-reimbursement type, and takes over performance as of the beginning of the fiscal year, 1 July, and retains many of the same employees. In this regard, Revenue Ruling 68-105 (C.B. 1968-1, 418) holds that a new contractor may qualify as a successor contractor, where the property used in the performance of the contracts is the same government-owned property. It is immaterial that no interest in the property used was acquired directly from the predecessor employer.

b. Section 3121(a)(1) of the Federal Insurance Contributions Act (FICA) and 3306(b)(1) of the Federal Unemployment Tax Act (FUTA), respectively, and the applicable regulations provide that the wages paid by a predecessor to an employee shall, for purposes of the annual wage limitation, be treated as having been paid to the employee by a successor, if (1) the successor during a calendar year acquired substantially all the property used in a trade or business, or used in a separate unit of a trade or business, of the predecessor; (2) the employee was employed in the trade or business of the predecessor immediately prior to the acquisition and is employed by the successor in his or her trade or business immediately after the acquisition; and (3) the wages were paid during the calendar year in which the acquisition occurred and prior to the acquisition. The method of acquisition by an employer of the property of another employer is immaterial. The acquisition may occur as the result of purchase or any other transaction where substantially all the property is acquired by the new employer.

c. If the new employer (contractor) meets these criteria, he or she may qualify as a successor employing unit so that for the purpose of establishing the wage limitations, remuneration paid to continuing employees by the predecessor during the calendar year and prior to the acquisition shall be considered as having been paid by the successor. The statutory minimums then apply to the combined earnings under both contractors. Additionally, the successor may be eligible to file with state authorities and obtain a lower merit unemployment tax rate based on the predecessor's experience at the location.

d. Where a contract changes hands under the foregoing circumstances, or the auditor has knowledge that such a change is to occur shortly, it is a matter of some urgency that the auditor takes the following steps on a timely basis.

(1) Ascertain whether the new contractor has determined that it qualified as a successor. If there is any doubt or question as to its status, the contractor should obtain a ruling from IRS.

(2) Determine that the successor obtains the predecessor's earnings record and tax payments records for the current year on the continuing employees.

(3) Determine that the successor, if qualified, ceases from incurring further costs for FICA and FUTA as soon as an employee's total combined earnings under both the predecessor and successor reach the statutory wage limitations.

(4) Where a lower merit rating is available under FUTA, based on the predecessor's experience at the location, determine that the successor has filed with state authorities and has obtained and is using the more favorable unemployment tax rate. However, there are some states which do not recognize predecessor experience as being eligible in obtaining a lower merit tax rate.

(5) In the event that taxes have been paid in excess of the proper amounts, determine that the successor obtains refunds and properly credits the government.

(6) Advise the contracting officer of any failure of the successor to take full advantage of its status as a successor employing unit under both FICA and FUTA.

7-1406 Employment Taxes in Mergers and Consolidations

a. The Internal Revenue Service has ruled (Revenue Ruling 62-60, C.B. 1962-1, 186) that, in the absorption of one corporation by another in a statutory merger or consolidation, the resultant entity is regarded as the same taxpayer and same employer as the absorbed corporation for FICA and FUTA purposes. Thus, there is no interruption in the employment status of the continuing employees and they are considered to have been in one employment throughout the year.

b. Where contractors have undergone statutory mergers or consolidation, the auditor should determine that FICA and FUTA taxes on the continuing employees are paid on the basis of a single employment for the year. Additionally, the auditor should ascertain whether credits for contributions to state unemployment funds and merit rating credits available to the absorbed corporation have been utilized by the surviving corporation.

7-1407 Federal Excise Taxes

Such taxes are allowable unless exemptions are available to the contractor (FAR 31.205-41(b)(3)). When there are substantial amounts involved (in either incurred or projected costs) and where there is a reasonable probability that the benefits of an exemption will outweigh the administrative burdens involved, the auditor should investigate the possibility that an exemption exists. If an exemption does not exist, appropriate inquiry or recommendation should be made to the contracting officer regarding the desirability of obtaining one.

7-1408 Foreign Taxes

a. When a contractor performs government contracts in foreign countries, whether under a Foreign Military Sales (FMS) contract or for domestic requirements, certain host countries impose taxes on the contractor. FAR 31.205-41(a)(1) specifically addresses the allowability of Federal, state, and local taxes without addressing the allowability of foreign taxes. Because foreign taxes are analogous to

state or local taxes, they are considered to be allowable contract costs.

b. When a contractor has paid an income tax to a host country, it can subsequently claim a foreign tax credit against its Federal income tax under Internal Revenue Code Section 901. If a contractor claim for a foreign tax credit is accepted by the Internal Revenue Service, it will result in a reduction in Federal income tax liability by the full amount of the credit. In that situation, the contractor would be duplicating the recovery of foreign income tax expenditures---first as a contract cost and second as a reduction in its Federal income tax liability.

c. This situation is addressed in contract clauses at FAR 52.229-6, 52.229-8, and 52.229-9 as well as in FAR 31.205-41(d).

(1) For fixed-price contracts, FAR 52.229-6(h) requires that if a contractor obtains a reduction in its U.S. tax liability because of the payment of any tax or duty which was included in the contract price, the amount of the reduction shall be paid or credited to the U.S. government as directed by the contracting officer.

(2) For cost-reimbursable contracts awarded on or after March 7, 1990, FAR 31.205-41(d), 52.229-8 and 52.229-9 require that contractors and subcontractors pay or credit to the U.S. government the amount of such reductions as directed by the contracting office unless the contract costs are being reimbursed by a foreign government. In the case of a foreign government reimbursing the contract costs, the contractor or subcontractor must repay the U.S. Treasury for any reduction in U.S. tax liability. FAR 52.229-9 specifically requires the payment to the Treasury and prohibits credit to a contract in such a case.

(3) For cost-reimbursable contracts awarded prior to March 7, 1990, FAR 31.201-5, "Credits," should be cited to assert the government's right to recover such reductions in U.S. tax liability.

d. Generally, foreign income taxes on the employee's salaries and wages are unallowable because they are a liability of the employee, not the contractor. However, contractors may be able to reimburse the employee and claim, as part of foreign differential pay, the difference between the employee's total income tax payment and the amount the employee would have incurred had the employee remained on domestic assignment. Refer to 7-2121 for guidance on the evaluation of employee foreign tax differential allowances.

e. Foreign taxes may include taxes levied for social insurance contributions in addition to income taxes. Social insurance contributions generally include payments for such items as retirement pay insurance, health insurance, unemployment insurance, nursing care insurance, and accident insurance. The employee's share of the social insurance contribution is generally not allowable because it is the employee's responsibility, not the contractor's. The contractor's share of the social insurance contribution is generally allowable in accordance with FAR 31.205-41(a)(1).

7-1409 Environmental Taxes

a. The Superfund Amendments and Reauthorization Act of 1986, Public Law 99-499, designated funding sources for the Hazardous Substance Response Trust Fund ("Superfund"). Among the sources is the Environmental ("Superfund") Tax enacted by Section 516 and codified at Section 59A of the Internal Revenue Code. The tax is placed in the subtitle devoted to income tax provisions. The positioning of the statute in this subtitle and the direct relationship of the tax rate to income denotes this as a tax on income. The tax is equal to 0.12 percent of that portion of the corporation's modified alternative minimum taxable income which exceeds $2,000,000.

b. For contracts awarded prior to January 22, 1991, the Superfund Tax is considered to be an expressly unallowable Federal income tax in accordance with FAR 31.205-41(b)(1). (Rockwell International Corporation v. Widnall, No. 96-1265 (April 1, 1997), aff"g ASBCA No. 46544, 96-1 BCA para 28,057.) Effective January 22, 1991, FAR 31.205-41(a) was revised to make the Superfund Tax a specifically allowable cost for contracts entered into on or after that date.

7-1500 Section 15 --- Independent Research and Development and Bid and Proposal Costs (IR&D and B&P)

7-1501 Introduction

a. A contractor's independent research and development effort (IR&D) is that technical effort that is not sponsored by, or required in performance of, a contract or grant and that consists of projects falling within the following four areas:

(1) basic research,

(2) applied research,

(3) development, and

(4) systems and other concept formulation studies.

Bid and proposal (B&P) costs are the expenses incurred in preparing, submitting, and supporting bids and proposals on potential government and non-government contracts. Coverage for both IR&D and B&P is contained in FAR 31.205-18 and in the DoD FAR Supplement 231.205-18.

b. All contractors (whether CAS covered or not) are subject to some or all of the provisions of CAS 420 (FAR 31.205-18(b)).

c. For CFYs beginning after September 30, 1992, the ceiling limitations for allowable IR&D and B&P costs that had been in place for many years were eliminated for most contractors. However, larger contractors were subject to a three year transition period of limited allowability for CFYs beginning after September 30, 1992. This three year transition period has ended, and there is no ceiling limitation for IR&D and B&P costs. The allowability of costs incurred during the first three CFYs beginning after September 30, 1992 is discussed in 7-1505. The allowability of costs incurred in CFYs beginning after September 30, 1995 is discussed in 7-1506. Special considerations for NASA contracts are discussed in 7-1508.

7-1502 Deferred IR&D and B&P

Deferred IR&D and B&P costs that were incurred in previous accounting periods are unallowable except when contract provisions specifically allow such costs. Refer to FAR 31.205-18(d) for details.

7-1503 General Considerations

a. Allowable IR&D and B&P costs for DoD contracts are limited to those projects which have "potential interest to DoD." DFARS 231.205-18(c)(2) provides seven broad categories of IR&D and B&P projects that are specifically defined to be of potential interest to DoD. These seven broad categories include activities that:

(1) Enable superior performance of future U.S. weapon systems and components;

(2) Reduce acquisition costs and life-cycle costs of military systems;

(3) Strengthen the U.S. defense industrial and technology base;

(4) Enhance the U.S. industrial competitiveness;

(5) Promote the development of technologies identified in the defense critical technologies plan that the Secretaries of Defense and Energy annually submit to Congress;

(6) Increase the development and promotion of efficient and effective applications of dual-use technologies; or,

(7)Provide efficient and effective technologies for achieving environmental benefits.

b. The broad definition of "potential interest to DoD" in DFARS reduces the probability that certain IR&D/B&P projects are unallowable due to a lack of potential DoD interest. However, the proper classification of costs between IR&D and contract costs remains a high-risk area (see 7-1505.1c). Auditors should consider these broad criteria when developing their audit scope, particularly when deciding to request a technical evaluation.

c. The auditor should identify any development projects that may have entered the production phase. Production phase costs should be eliminated from any IR&D project costs. IR&D projects that have been incurring costs for a long time should be reviewed to determine if demonstrable progress is being made. These long-term projects should be brought to the attention

of the contracting officer. In many cases, determination of reasonable progress cannot be made by the auditor without technical assistance.

d. Contractor contributions to cooperative research and development consortiums should be reviewed to determine whether the costs should be classified as IR&D or as consortium costs. Consortium costs are discussed in 7-2115.

e. The FAR states that costs for IR&D and B&P projects should be accounted for in the same manner as contracts and include all related direct costs and allocable indirect costs.

f. B&P costs, as defined in FAR 31.205-18(a), include all costs incurred in preparing, submitting, and supporting bids and proposals. CAS 420.50(a)(1) states the B&P project costs shall include costs that, if incurred in like circumstances for a final cost objective, would be treated as direct costs of that final cost objective. Therefore, if a contractor charges administrative costs (such as typing and technical support) directly to final cost objectives, then it must also charge them directly to B&P final cost objectives. If, however, the contractor charges administrative costs to indirect cost pools, such costs may continue to be charged to indirect cost pools. The auditor's review should include appropriate tests to assure consistent application of disclosed practices. In addition, the auditor should assure that the contractor's accounting practices for the treatment of administrative costs comply with CAS 410.30(a)(6), 410.50(d), 418.30(a)(3), and 418.50(b)(2).

g. CAS 402.61, Interpretation, addresses the treatment of proposal preparation costs under the standard. The interpretation explains that proposal preparation costs may be treated as direct or indirect depending on the circumstances under which the costs are incurred. Proposal preparation costs which arise as a result of a specific contract requirement (e.g., follow-on contracts) may be treated as direct costs while ordinary B&P effort (i.e., effort that is not required by a contract) is treated as indirect. However, contractors may elect to charge all B&P costs indirect, including those performed as a specific contract requirement, so long as the practice is applied consistently and the practice results in an equitable distribution to all final cost objectives. The concept explained in the interpretation should be applied to B&P effort for solicitations under indefinite delivery/indefinite quantity (ID/IQ) contracts. ID/IQ contracts typically include an initial minimum award with subsequent orders competitively solicited under the basic ID/IQ contract. Although such proposal effort can be identified to an ID/IQ contract, it is generally performed to obtain new work and is, in substance, the same as B&P effort for obtaining future contracts. Therefore, a contractor may elect to allocate its ID/IQ B&P costs as a direct charge to the ID/IQ contract if there is a specific contract requirement, or include ID/IQ B&P costs in its indirect B&P allocation, so long as the practice is consistently applied and the practice results in an equitable distribution to all final cost objectives.

h. Advance agreements may include a provision stating how the costs are to be allocated. In these cases the auditor should determine if the costs are properly classified and allocated in accordance with the agreement.

i. If the contractor's products are varied and a division of production and sales responsibility is clearly maintained, only IR&D and B&P costs of the profit center concerned with government contracts should be considered for purposes of allocation to contract costs. As a general rule, IR&D and B&P costs shall be allocated to contracts on the same basis as the general and administrative expenses. Where specific projects clearly benefit other profit centers or the entire company, such costs shall be allocated through the G&A of such other profit centers or through the corporate G&A, as appropriate. The contracting officer may approve the use of a different base of allocation in those instances where allocation through G&A does not provide equitable cost allocation. The auditor's determinations regarding allocability will be included as part of the advisory report.

7-1504 Special Consideration for B&P Support Costs

a. B&P costs, as defined in FAR 31.205-18(a), include the costs of techni-

cal personnel engaged in the preparation and publication of cost and other administrative data necessary to support the contractor's bids and proposals. These administrative costs should be handled consistently with similar costs in the contractor's accounting system. In addition, the cost of technical personnel engaged in the development and preparation of the technical proposal document is to be separately identified and classified as direct B&P costs subject to allocation of all allocable indirect expenses, except for G&A.

b. FAR 31.205-18(a) and CAS 420 require the contractor to charge attendance at meetings in support of a bid or proposal by direct labor employees directly to the B&P project involved, unless the attendance is sponsored by a grant or required in the performance of a contract. Both FAR and CAS define bid and proposal costs as costs incurred in preparing, submitting, and supporting bids and proposals (whether or not solicited) on potential government or non-government contracts. In addition, CAS 420.50(a) provides that IR&D and B&P project costs shall include costs that, if incurred in like circumstances for a final cost objective, would be treated as direct costs of that final cost objective. Costs for direct labor employees attending a meeting at a government procurement office in support of a contract represent circumstances similar to direct labor personnel attending meetings in support of a bid or proposal. In the case of contract support, the direct labor personnel are interacting with procurement to perform work on a contract; in the case of a bid or proposal, the direct labor personnel are interacting with procurement to perform work on a bid or proposal (assuming that the attendance is not sponsored by a grant or required in the performance of a contract). The first situation is directly related to a contract; the second situation is directly related to a B&P project. Because the contract labor and related travel costs are charged directly to the contract, CAS 420.50(a) requires that the attendance at meetings in support of a bid or proposal and related travel costs be charged directly to the B&P project.

7-1505 IR&D and B&P Allowability Criteria for the First Three CFYs Beginning After September 30, 1992

7-1505.1 General Considerations

a. FAC 90-13 and DAC 91-4 implemented the requirements of Public Law 102-190. Those rules removed IR&D and B&P costs allowability ceilings from most contractors. The intent of the law and its implementing rules is to have IR&D and B&P costs treated as other costs are considered without specific ceiling limitations. The criteria for reviewing these costs will include allowability, allocability, and reasonableness.

b. Contractors' segments with significant amounts of flexibly priced government contracts continued to have a new type of ceiling on IR&D and B&P costs allocable to government contracts until the completion of the first three full CFYs beginning after September 30, 1992 (see 7-1505.2 and 7-1505.3).

c. Under prior IR&D and B&P rules there was a risk that IR&D and B&P costs would be mischarged to cost-type contracts as the contractor neared its ceiling limitation for the year. That risk is lessened by the current FAR coverage. However, there is a continuing audit risk that research and development performed directly for a contract may be mischarged from fixed price contracts, flexibly priced contracts with a potential for cost overruns, or commercial contracts.

d. There is no ceiling limitation except reasonableness for any contractor that does not meet the $10 million threshold (7-1505.2c), nor for any contractor segment that does not meet the $1 million threshold (7-1505.2b), even if the contractor meets the $10 million threshold.

7-1505.2 Determination of Contractor Segments Subject to a Ceiling Limitation

a. "Covered" contracts are government contracts (or subcontracts under a "covered" prime contract) for amounts in excess of $100,000, except for fixed-price contracts without cost incentives.

b. A "covered segment" is a segment of a company with over $1 million of IR&D

and B&P costs allocated during its prior fiscal year to "covered" contracts. IR&D and B&P costs of segments that are not "covered" are not counted in determining if a contractor meets the $10 million threshold discussed below.

c. The ceiling applies (only for the first three CFYs beginning after September 30, 1992) to a contractor with over $10 million of IR&D and B&P costs allocated during its prior fiscal year to "covered" contracts at its "covered segments."

d. Only the IR&D and B&P costs of "covered segments" of contractors exceeding the $10 million threshold are subject to the new ceiling limitation.

7-1505.3 Calculation of Ceiling Limitation

a. The ceiling limitation is calculated using a new formula applied to actual costs incurred. The formula for the limitation on current year's cost begins with the allowable amount of IR&D and B&P costs incurred at "covered segments" during the previous year. To determine the ceiling amount the prior year's allowable amount is first automatically increased by 5 percent. The prior year's allowable amount is also increased by an additional percentage if the contractor incurs more for IR&D and B&P in the current year than it did in the prior year. The additional increase is proportional to the contractor's spending increase, but is limited to the price escalation index for the Research, Development, Test, & Evaluation (RDT&E) account, Total Obligation Authority (TOA) published annually by the DoD Comptroller.

b. As updated through December 14, 1995, the RDT&E TOA indices are currently 2.6 percent for Government Fiscal Year (GFY) 1993, 2.5 percent for GFY 1994, 2.9 percent for GFY 1995, and 3.0 percent for GFY 1996.

c. The following ceiling calculation example is for a calendar year contractor that had an advance agreement ceiling negotiated under the old cost principle, exceeds the $10 million threshold for its covered segments for all years in the example, and has a constant 80 percent DoD negotiated contract share of the total business base. Its CFY 1993 would be the first year subject to the new cost principle's ceiling and its CFY 1995 would be the last. The example is provided assuming that all amounts are incurred costs. For forward pricing, the amounts would be projected. Because the ceiling amounts depend on prior years' actual costs, the actual limitations would change if the costs incurred differed from the projections. In the example, the negotiated ceiling for 1992 was $30 million. All dollar amounts are in millions and represent only the costs allocable to "covered segments."

Costs Incurred at Segments Meeting $1 Million Threshold (note 3)	Amounts in Millions 1992	1993	1994	1995	1996
1. Incurred IR&D/B&P Costs	20.0	30.0	25.0	25.3	40.0 (note 1)
2. Prior Year's Allowable Amount	NA	20.0	21.5	22.6	NA
3. 5% Increase (5% of Line 2)	NA	1.0	1.1	1.1	
4. Percentage Increase in Costs*	NA	50.0%	0%	1.2%	
5. RDT&E TOA Escalation Index**	NA	2.6%	2.7%	2.9%	
6. Lesser of Lines 4 or 5	NA	2.6%	0%	1.2%	
7. Ceiling Increase Based on Spending Increase (Line 6 X Line 2)	NA	.5	0.0	.3	
8. Ceiling (Line 2 + Line 3 + Line 7)	30.0	21.5	22.6	24.0	
9. Allowable IR&D/B&P (Lower of Lines 1 or 8) (note 4)	20.0	21.5	22.6	24.0	40.0
10. IR&D/B&P Costs with DoD Potential (note 2)	18.0	25.5	20.0	20.0	NA
11. Share of IR&D/B&P Allowable Under FAR Allocated to DoD (80% of Line 9)	16.0	17.2	18.1	19.2	NA
12. Allowable Total IR&D/B&P under DFARS for DoD Contracts (Lower of Lines 10 or 11)	16.0	17.2	18.1	19.2	NA

NA = Not Applicable
* = (Current Year - Prior Year) / Prior Year, But Not Less Than 0%.
** = The rates shown are from January 1994 projections and change annually.

Notes on the Example:

(1) In the example for 1996, the contractor's IR&D and B&P costs are no longer subject to the ceiling limitations.

(2) Given the broad definition of "potential interest to DoD" in the DFARS, the risk is low that the costs would not meet the definition. The "potential interest" amount normally is the result of a technical review. If the amount on line 10 is ever less than the amount on line 11 for a year, there must be a lower IR&D-B&P rate calculated for allocation to DoD contracts to ensure that no more than the amount on line 12 is allocated to DoD.

(3) If the segments meeting the $1 million threshold change from one year to the next, it may affect the contractor's $10 million threshold coverage. The calculation of the current year's limitation on allowable costs must be based on the prior and current years' costs for the segments that are to be covered by the limitation being calculated.

(4) The ceiling calculated using the new FAR formula (FAC 90-13) must be increased if the contracting officer determines that the new ceiling formula would reimburse the contractor less than the contractor would have received under the rule prior to FAC 90-13.

7-1506 IR&D and B&P Allowability Criteria for CFYs Beginning After September 30, 1995

FAC 97-03 implemented the intent of Congress in Public Law 102-190 to eliminate over a three year period any allowability ceiling for IR&D and B&P costs and treat these costs for FY 1996 and beyond as fully allowable, subject only to the FAR standards of reasonableness and allocability. The final rule (FAC 97-03), effective February 9, 1998, removed for fiscal year 1996 and beyond the requirements to calculate or negotiate a ceiling for IR&D and B&P costs. Costs for IR&D and B&P are allowable as indirect expenses on contracts for all contractors to the extent that those costs are allocable and reasonable.

7-1507 Cooperative Arrangements/Agreements

a. FAR 31.205-18(e)(1) provides that costs incurred by a contractor working jointly with one or more non-Federal entities pursuant to cooperative arrangements (e.g., joint ventures, limited partnerships, teaming arrangements, and collaboration and consortium arrangements) or costs contributed by a contractor in performing cooperative research and development agreements entered into under any of the authorities listed below, should be considered as allowable IR&D costs if the work performed would have been allowed as IR&D had there been no cooperative arrangement:

(1) Section 12 of the Stevenson-Wydler Technology Transfer Act;

(2) For contracts awarded prior to May 16, 1997 - Sections 203(c)(5) and (6) of the National Aeronautics and Space Act of 1958, as amended, when there is no transfer of Federally appropriated funds;

(3) For contracts awarded on or after May 16, 1997 - Section 203(c)(5) and (6) of the National Aeronautics and Space Act of 1958, as amended;

(4) 10 U.S.C. 2371 for the Defense Advanced Research Projects Agency; or

(5) Other equivalent authority.

b. Contracts awarded prior to May 16, 1997. Effective May 2, 1994, NASA issued a class deviation from FAR 31.205-18(e)(2). Under this class deviation, costs incurred under NASA cooperative arrangements, regardless of whether or not there is a transfer of federally appropriated funds, may be charged to IR&D and allocated to contracts in accordance with the contractor's established practice, provided the work performed would have been allowed as IR&D had there been no cooperative arrangement.

c. Contracts awarded on or after May 16, 1997. Effective May 16, 1997, FAR 31.205-18(e) was revised to permit contractor IR&D contributions under NASA cooperative arrangements to be treated as allowable indirect costs. The FAR revision eliminated the need for the prior NASA class deviation (see paragraph b.).

d. “Other equivalent authority”, as referred to in FAR 31.205-18(e)(1)(iv), applies to any cooperative research and development agreement, or similar arrangement, entered into under a statutory authority. When contractors classify costs incurred under such arrangements as IR&D, the auditor should coordinate with the agency that awarded the arrangement to determine if the arrangement is entered into under a statutory authority. The auditor should adequately document this coordination in the working papers and/or audit report.

e. For contracts awarded on or after February 9, 1998 (FAC 97-03), costs incurred in preparing, submitting, and supporting offers on potential cooperative arrangements are allowable to the extent they are allocable, reasonable, and not otherwise unallowable.

7-1508 Special Consideration for IR&D and B&P in NASA Contracts

The auditor must review the effective date of the contract to determine if the contract is covered by the FAR or by the NASA Procurement Regulations. Special considerations are needed for contracts subject to the NASA Procurement Regulations.

7-1508.1 NASA Contracts Entered Into Under the FAR

The FAR provisions apply to all NASA contracts entered into on or after April 1, 1984. The NASA FAR Supplement has no special requirements for IR&D and B&P costs. Therefore, no special considerations are required for NASA contracts entered into under the FAR.

7-1508.2 NASA Contracts Entered Into Under the NASA Procurement Regulations (NASA PR)

a. The NASA PR generally applies to all NASA contracts entered into prior to the implementation of the FAR on April 1, 1984. The NASA PR cost principles covering IR&D and B&P costs are in conformity with the DAR cost principles in effect at the time for matters of definitions, burdening, and allocation procedures. Both sets of cost principles provide that IR&D

and B&P costs are allowable to the extent that the costs are allocable and determined to be reasonable in amount. However, the NASA PR reflects somewhat different provisions regarding the determination of reasonableness and deferred IR&D costs as follows:

(1) The NASA PR cost principles do not establish any thresholds for entering into advance agreements, assign responsibilities for initiating negotiations, or provide any penalties for the failure to do so.

(2) Potential interest to DoD (prior to August 19, 1991, potential relationship to a military function or operation), or the NASA equivalent, is not a factor.

(3) There is no provision for formula calculation or comparable basis for determining reasonableness for contractors not considered major.

b. Clarification of the differences in allowability provisions between DAR and NASA PR follows:

(1) NASA PR has no requirement for potential interest or relationship (see 7-1503a). The ceiling amount negotiated by DoD should not be affected by the relevancy rule applicable to DoD inasmuch as nonrelevant projects are to be included in the total program base from which the ceiling is developed. Thus, NASA will normally accept, as in the past, its allocable share of expenditures for IR&D and B&P within the dollar ceiling negotiated by DoD and/or NASA under an advance agreement.

(2) NASA will be guided by the formula results accepted by the DoD contracting officer as reasonable in those cases where an advance agreement is not required.

(3) NASA reserves the right, as always, to withdraw its support from and/or participation in individual negotiations if it appears that NASA's best interests will be adversely affected by the terms and conditions of the proposed agreement. In such cases NASA will make a proper and timely notification of its decision to withdraw to all interested parties.

c. Accordingly, the following audit guidance is applicable to NASA PR contracts:

(1) Audit findings directed to NASA may be generally predicated on the same justifications as those used for DoD purposes except:

(a) When peculiar and unusual conditions exist at a particular contractor location with respect to NASA contracts;

(b) In those cases where an advance agreement is required by FAR, but the contractor has not initiated negotiations;

(c) When an advance agreement is required, negotiations have been held, but an advance agreement has not been reached and the contracting officer has substantially reduced payment below that which the contractor would otherwise have received; or

(d) In situations involving either deferred independent or sponsored research and development.

(2) Under these circumstances the audit report shall include all pertinent factual data, comments, and recommendations to assist the NASA contracting officer in reaching a conclusion

7-1600 Section 16 --- Warranty Costs and/or Correction of Defect Costs

7-1601 Introduction

a. This section covers the various warranty clauses that may be used in contracts awarded by the Federal government.

b. This section also presents general guidance in reviewing estimated and/or actual warranty costs and the various methods in accounting for warranty costs.

7-1602 FAR Warranty Clauses Affecting Warranty Cost

Warranty clauses or correction of defects clauses are included in some contracts to give the government certain rights and remedies if supplies or service furnished under the contract are found to be defective or deficient within a prescribed period. Generally, a warranty should provide that, for a stated period of time or use, or until the occurrence of a specified event, the government has a contractual right for the correction of defects (see FAR 46.702). The FAR contains the following warranty clause requirements:

a. Except for clauses governing cost-reimbursement supply contracts (FAR 52.246-3), and cost-reimbursement research and development contracts (FAR 52.246-8), warranties are not included in cost-reimbursement type contracts (FAR 46.705).

b. FAR 46.703 provides criteria for determining whether a warranty is appropriate for a specific acquisition, other than in those situations discussed in paragraph a. above.

c. When a warranty is to be included in a contract, the terms and conditions may vary with the circumstances of the procurement. FAR 46.706(a) requires that the following items be clearly stated in the warranty clause:

(1) The exact nature of the item and its components and characteristics that the contractor warrants;

(2) The extent of the contractor's warranty including all of the contractor's obligations to the government for breach of warranty;

(3) The specific remedies available to the government, such as payment of the costs incurred by the government in procuring the items from another source, the right to an equitable reduction of the contract price, or that the contractor repair or replace the defective items at no additional cost to the government, and;

(4) The scope and duration of the warranty.

7-1603 Definition of Warranty Costs and Accounting for Such Cost

a. For purposes of the following guidance, the term "warranty costs" encompasses costs related to (1) the warranty aspects of the Inspection of Supplies clause at FAR 52.246-3 and (2) warranty clauses. FAR 46.703(b) states that "Warranty costs arise from the contractor's charge for accepting the deferred liability created by the warranty. . ." The acquisition cost of a warranty may be included as part of an item's price or may be set forth as a separate contract line item (see DFARS 246.703(b)). The warranty clauses specify that a contractor's cost of compliance with the provisions of the warranty will be at the contractor's expense with no increase in contract price.

b. A warranty may cover all costs of repairs regardless of the actual reimbursement for repair costs. For example, the contract may provide for reimbursing the contractor $50,000 to cover all repairs done during a specified time period. Thus, regardless of how much the actual repairs are (e.g., $20,000, $60,000, $100,000, etc.), the contractor will be reimbursed $50,000.

c. Alternatively, warranty may cover the cost of repairs up to a ceiling amount. For example, the contract may provide reimbursement of $75,000 to cover repairs, with a warranty ceiling of $175,000 (with any actual costs incurred in excess of the warranty ceiling reimbursed on a dollar-for-dollar basis). Under such an arrangement, if the actual repair costs were $30,000, the contractor would receive $75,000. If the actual repair costs were $125,000, the contractor would still receive only $75,000. However, if the actual repair costs were $200,000, the contractor

would receive $100,000 ($75,000 covered by the warranty agreement, plus an additional $25,000 of actual repair costs in excess of the ceiling amount ($200,000 less $175,000)).

d. The audit of estimated or incurred warranty costs is dependent upon the terms of the contracts and the contractor's accounting policies and procedures. The contractor should maintain written accounting practices and procedures describing how the warranty costs are accounted for. For CAS-covered contractors, these accounting practices should be part of the disclosure statement. Warranty costs may be accounted for (1) as a direct contract cost, (2) as an indirect cost on the basis of actual expenditures in the period of incurrence, or (3) as an indirect cost on the basis of a reserve. The use of this last method is similar to that generally used in accounting for bad debt losses.

7-1604 General Audit Considerations

The following points should be considered when evaluating warranty costs included in contractors' cost submissions or pricing proposals:

a. When briefing contracts and/or auditing specific contract costs, the auditor should be alert to whether or not there is a warranty clause, and whether the clause includes a warranty ceiling. If the contract includes warranty coverage, the clause should be examined to determine the period covered by the warranty, the warranty terms, and that the warranty costs reviewed are allowable under the contract. The auditor should communicate with the Contracting Officer to assure a proper interpretation of the warranty provisions.

b. When express warranties are included in contracts (except contracts for commercial items) all implied warranties of merchantability and fitness are negated by use of the language in the warranty clause (see FAR 46.706(b)(1)(iii)). Under cost-reimbursement type contracts, the Inspection of Supplies clause provides that corrections or replacements are to be made without cost to the government if the defects are the result of fraud or other causes of the types listed in FAR 52.246-3(h). In the absence of such causes, costs of correcting defects may be allowable if incurred within the period covered by the clause.

c. Verify actual costs to ensure that contractors have properly segregated warranty costs for the correction of defects from the costs of ongoing performance (such as redesign, rework, test and quality control). In many cases, the department or group tasked with correcting a defect under the warranty requirements will be the same department or group performing the ongoing portion of the contract. The auditor should ascertain whether the contractor has established procedures for reviewing items processed for correction of defects and for determining the reason(s) for the defects and the extent of its responsibility. In some cases, where costs are relatively large, the auditor may obtain technical advice from government technical personnel prior to accepting such costs.

d. Determine whether the contractor's policies and procedures for allocating warranty costs are equitable and give effect to any existing significant differences in warranty conditions or costs among the various items or product lines produced by the contractor. For example, if a contractor produces several items or product lines which have significant differences in types of warranties offered, or in the warranty costs incurred, the auditor should ascertain that the basis of allocation to the particular items or product lines appropriately reflects these differences. When warranty costs are included in overhead, the auditor should determine that the base for allocating this expense is made up only of contracts containing warranty provisions. When evaluating direct charges to a contract for warranty costs, the auditor should ascertain that the same type of costs incurred on other government or commercial products are excluded from allocable overhead unless it is clearly established that a cost duplication does not exist.

e. Determine whether the contractor's policies and procedures are being followed and properly implemented. To ascertain this, a representative number of transactions should be reviewed. When warranty costs are accounted for under the reserve method, the auditor should ascertain that the periodic charges to overhead and addi-

tions to the reserve account are not excessive in relation to actual warranty costs experienced over an appropriate number of years.

f. When there is a warranty ceiling, the auditor should assure that any claimed repair costs are limited to those in excess of the warranty ceiling.

g. Some warranty clauses permit the government to perform the repair work themselves, with the contractor required to reimburse the government (either through payment or credit) for the work performed. When the contract contains this type of clause, the auditor should coordinate with the PCO/ACO to determine if any amounts owed by the contractor have been recovered. If it is determined that significant monies owed have not been recovered, the auditor should formally notify the PCO/ACO of the amount owed so that the PCO/ACO can take the appropriate collection action.

h. In estimating costs to provide a warranty, contractors must consider many factors, including the specific warranty terms, the types of defects which may occur, the probability and number of occurrences, and the nature, extent, and cost of the corrective action which will be required. In the evaluation of proposed warranty costs, the following steps should be performed:

(1) Review the warranty provisions in the request for proposal to ascertain that a warranty is required and to determine the nature and extent of the warranty requirements.

(2) Evaluate the contractor's accounting policies and procedures for the treatment and segregation of warranty costs. Review the practices to determine if any inequity exists in allocating costs between and among commercial and government work loads.

(3) Determine the basis of the proposed warranty costs. The estimates should be based on auditable data such as actual experience, industry-wide experience, actuarial estimates or parametric estimates (see 9-1000). If estimated costs are predicated on incurred costs related to isolated events which are nonrecurring, a contingency exists; therefore, attention should be given to FAR 31.205-7, "Contingencies."

(4) Evaluate the contractor's past experience in the actual incurrence of warranty cost.

(5) Determine if there are any discernible trends or changes in accounting or operating practices which are likely to affect warranty costs in future periods.

(6) Determine that warranty costs charged direct on prior contracts are excluded from the base amounts used to project future product costs on follow-on contracts.

(7) When the examination relates to a proposal for a contract where a warranty may be appropriate (see 7-1602), the audit report should include any comments which would assist the contracting officer in determining (a) whether the best interest of the government would be served by including a warranty clause in the contract, (b) the approximate cost to the government for the protection afforded by such clause (the amount not questioned), and (c) whether major subcontracts include warranty provisions. If so, the report should also include comments on vendor warranty costs, particularly in cases where the express or implied contractor or vendor policy is that vendor warranties will not be passed to the government. This may require an assessment of (i) the dollar impact of warranty costs included in vendor prices, and (ii) the need for the contractor to have warranty protection when material is purchased for inventory or for other prudent reasons. Where determinable, the report should include a statement to the effect that the contractor's proposal costs include amounts for either vendor or contractor warranty, even though the dollar impact may not be quantifiable.

(8) When the examination relates to a proposal for a contract not includinga warranty clause (see 7-1602), comments similar to those provided in (7) above would not be appropriate. However, those contractor proposals may contain an "inspection clause," and should include a reasonable estimate for costs of complying with the requirements of the related contract clause (see FAR 52.246). The omission or understatement of such costs may result in the negotiation of a contract with a built-in overrun factor. If the auditor encounters an

apparently inappropriate omission, this should be brought to the attention of the contractor and the appropriate contracting officers. The auditor should not prepare the proposed estimate for the contractor. However, the auditor should disclose any deficiency in the narrative report comments with attention to the appropriate contractor responsibilities addressed at FAR 46.105, 46.202, and 46.3.

i. Other Audit Considerations

Other areas that may require special consideration in the audit of warranty costs include CAS compliance and the use of offsite indirect expense pools.

(1) DFARS 246.703(b) provides that warranty costs may be included as a separate contract line item. If the contractor proposes warranty costs as a separate line item, the auditor should verify that this is in compliance with the contractor's disclosed practice. In addition, consideration must be given to the requirements of CAS 402 which requires consistency in the allocation of costs incurred for the same purpose in like circumstances (see 8-402).

(2) Another audit concern resulting from the inclusion of warranty clauses in contracts relates to the use or establishment of offsite overhead pools to accumulate and allocate expenses related to effort of correcting defects at offsite locations (for example, correction of a defect at a government installation). The audit of costs associated with offsite activities would include a determination of whether the effort is of such magnitude as to justify establishment of a separate cost pool, and whether the allocation method used satisfies the requirements of FAR 31.203 and, if applicable, CAS 418 (see 6-606 and 8-418).

7-1605 Coordination with the PCO/ACO and Technical Staff on Warranty Costs

The technical nature of the subject matter and the relevancy of interpretation of contract provisions on warranty costs make it especially important that the auditor coordinate with the PCO/ACO and their technical staff.

7-1606 Audit Considerations of Warranty Costs in Negotiating Final Price under Fixed-Price Incentive Contracts

The final total price negotiated under a fixed-price incentive contract containing a warranty clause may consider all costs incurred or to be incurred by the contractor in complying with the warranty clause (see FAR 46.707). When it is the contractor's practice to account for warranty cost as a direct charge or by establishing a reserve (see 7-1603 b), its repricing proposal for the above purpose may include an estimate of warranty costs remaining to be incurred. In such cases the auditor should examine closely the basis for the estimates and their reasonableness.

7-1700 Section 17 --- Business Combination Costs

7-1701 Introduction

This section provides guidance for audit evaluation of business combination costs proposed or claimed by contractors.

7-1702 Business Combinations

a. A business combination occurs when an entity acquires net assets that constitute a business or acquires equity interests of one or more other entities and obtains control over the entity or entities. The new entity carries on the activities of the previously separate, independent enterprises (see FASB Statement No. 141).

b. Once an auditor becomes aware of a business combination whether it be through a merger, consolidation, acquisition, divestiture, etc., he/she should take the following steps:

(1) Contact the contractor immediately to obtain information on the situation.

(2) Request that the contractor keep DCAA advised of all related transactions and activities as they occur.

(3) Remind the contractor of the FAR and CAS requirements concerning affected costs, including the requirement that unallowable costs together with directly associated costs be identified and excluded from any claim applicable to the government.

(4) Maintain contact between and among the affected FAOs to assure a complete exchange of information, and to ensure that consistent audit action is being taken. Where there is a Contract Audit Coordinator (CAC) or a Corporate Home Office Auditor (CHOA) (see 15-200), overall coordination responsibility should reside therein.

(5) Contact the ACO and the major buying commands to ensure that they are aware of the circumstances. There should be a complete exchange of information with emphasis on items such as advance agreements and novation agreements.

(6) Evaluate the benefits of having a CAC or CHOA conference or a meeting of the auditors cognizant of the specific organizational units involved in the change.

7-1703 Basic Approaches to Obtaining Control Over Assets Owned and Used by Other Firms (Business Acquisition)

There are two basic approaches to obtaining control over assets owned and used by other firms. The acquiring firm may buy the desired assets and thereby obtain title to their use directly, or it may obtain an ownership interest in the common stock of another company enabling it to exercise indirect control over the other firm's assets. These two basic approaches can be adopted in various forms, as follows:

- Acquisition of assets.
- Acquisition of stock.
- Statutory merger.
- Statutory consolidation.

7-1703.1 Acquisition of Assets

a. The acquisition of assets under a business combination is more than a casual sale and purchase of an asset. It is the purchase and sale of a major amount of operating assets, requiring approval by each company's board of directors and, generally, its stockholders. Payment for the assets may be made by cash, debt securities, the acquiring firm's stock, or a combination thereof.

b. The acquiring corporation may (1) create a new corporation for the assets, (2) assign the assets to a new division or branch, or (3) assimilate the assets into its present organization. An important point to bear in mind is that purchasing the assets does not give the acquiring firm any ownership rights in the selling organization. The acquiring firm is buying title to specific assets and is in no way acquiring any stockholders' rights in the selling firm.

7-1703.2 Acquisition of Stock

Instead of buying assets directly, an acquiring firm may gain control of assets by buying the voting common stock of the investee. Voting stock may be acquired by (1) purchase of outstanding stock on the open market, (2) negotiation with major stockholders to purchase all or part of their

interests, (3) purchase of authorized but unissued shares (including treasury stock) from the investee company, and (4) a tender offer. In a tender offer, the investor makes a public announcement to the stockholders of the corporation whose stock the investor wishes to purchase. The announcement stipulates the price offered for the shares and the number of shares the potential investors want to purchase, what will happen if more or less than that number are tendered, and the time period for tendering the stock. Information regarding the tender offer must be filed with the Securities and Exchange Commission prior to making the offer.

7-1703.3 Statutory Merger

A statutory merger occurs when one or more corporations give up their separate legal identities to another constituent corporation which maintains its identity. Stockholders of the liquidated corporation usually receive common stock of the surviving corporation, but they may also receive cash, debt securities, or preferred stock. Normally, a statutory merger must be approved by the boards of directors of the constituent corporations and then by the stockholders of each company.

7-1703.4 Statutory Consolidation

A statutory consolidation is similar to a statutory merger in that the consolidation must be approved by the boards of directors and stockholders of the constituent corporations. Unlike a merger, however, a consolidation results in the formation of a new corporation and the liquidation of the constituent corporations. The shareholders of the constituent corporations are issued stock in the new corporation, which then controls the assets and liabilities of the former constituent corporations.

7-1704 Accounting for Business Combinations

7-1704.1 Introduction and Use

FASB Statement No. 141 requires that all business combinations initiated after June 30, 2001 must be accounted for using the purchase method. Prior to this date the pooling of interest method was acceptable under certain circumstances. (See editions of CAM prior to July 2003 for discussion of the pooling of interest method.)

7-1704.2 Purchase Method

a. The purchase method reflects the acquisition of one company by another. The excess, if any, of the fair value of the identifiable assets purchased over the fair value of the liabilities assumed and the amount paid is recorded as goodwill. Goodwill is an expressly unallowable cost. Also, goodwill is an unallowable element of the facilities capital employed base used to compute cost of money.

b. The effect of using the purchase method on the valuation of acquired assets is stated in paragraph 7 of FASB Statement No. 141. It requires that the cost of each individual asset be determined based on its estimated fair value at the date of acquisition. Any excess of the price paid for the acquired business over the sum of the amounts assigned to all recognized assets acquired less liabilities assumed is assigned to unidentified assets, including goodwill.

c. In a business combination, a write-up (or write-down) of the asset values can occur when the fair value of the assets acquired is more (or less) than the book value of the assets (7-1705.1). Costs assigned to intangible assets should reasonably reflect their fair market value (7-1705.2).

d. For more specific guidance relating to the valuation or write-up of assets under the purchase accounting method, see 7-1705 below.

7-1705 Asset Valuation and Revaluation Resulting from Business Combinations

7-1705.1 GAAP for Write-ups (or Write-downs)

a. The GAAP for determining the value of an acquired company's assets and liabilities are principally provided in Statement of Financial Accounting Standards No. 141. Five paragraphs are restated below.

(1) Paragraph 7 - Allocating cost. Acquiring assets in groups requires not only ascertaining the cost of the asset (or net asset) group but also allocating that

cost to the individual assets (or individual assets and liabilities) that make up the group. The cost of such a group is determined using the concepts described in paragraphs 5 and 6. A portion of the cost of the group is then assigned to each individual asset (or individual assets and liabilities) acquired on the basis of its fair value. In a business combination, an excess of the cost of the group over the sum of the amounts assigned to the tangible assets, financial assets, and separately recognized intangible assets acquired less liabilities assumed is evidence of an unidentified intangible asset or assets.

(2) Paragraphs 35 and 36 - Allocating the Cost of an Acquired Entity to Assets Acquired and Liabilities Assumed.

Following the process described in paragraphs 36-46 (commonly referred to as the purchase price allocation), an acquiring entity shall allocate the cost of an acquired entity to the assets acquired and liabilities assumed based on their estimated fair values at date of acquisition (refer to paragraph 48). Prior to that allocation, the acquiring entity shall (a) review the purchase consideration if other than cash to ensure that it has been valued in accordance with the requirements in paragraphs 20-23 and (b) identify all of the assets acquired and liabilities assumed, including intangible assets that meet the recognition criteria in paragraph 39, regardless of whether they had been recorded in the financial statements of the acquired entity.

Among other sources of relevant information, independent appraisals and actuarial or other valuations may be used as an aid in determining the estimated fair values of assets acquired and liabilities assumed. The tax basis of an asset or liability shall not be a factor in determining its estimated fair value.

(3) Paragraphs 37 and 38 - Assets acquired and liabilities assumed, except goodwill.

The following is general guidance for assigning amounts to assets acquired and liabilities assumed, except goodwill:

(a) Marketable securities at fair values.

(b) Receivables at present values of amounts to be received determined at appropriate current interest rates, less allowances for uncollectibility and collection costs, if necessary.

(c) Inventories.

- Finished goods and merchandise at estimated selling prices less the sum of (a) costs of disposal and (b) a reasonable profit allowance for the selling effort of the acquiring entity.

- Work in process at estimated selling prices of finished goods less the sum of (a) costs to complete, (b) costs of disposal, and (c) a reasonable profit allowance for the completing and selling effort of the acquiring entity based on profit for similar finished goods.

- Raw materials at current replacement costs.

(d) Plant and equipment.

- To be used, at the current replacement cost for similar capacity unless the expected future use of the assets indicates a lower value to the acquiring entity (Note - Replacement cost may be determined directly if a used-asset market exists for the assets acquired. Otherwise, the replacement cost should be estimated from the replacement cost new less estimated accumulated depreciation.)

- To be sold, at fair value less cost to sell.

(e) Intangible assets that meet the criteria in paragraph 39 at estimated fair values.

(f) Other assets, including land, natural resources, and nonmarketable securities, at appraised values.

(g) Accounts and notes payable, long-term debt, and other claims payable, at present values of amounts to be paid determined at appropriate current interest rates.

An acquiring entity shall not recognize the goodwill previously recorded by an acquired entity, nor shall it recognize the deferred income taxes recorded by an acquired entity before its acquisition. A deferred tax liability or asset shall be recognized for differences between the assigned values and the tax bases of the recognized assets acquired and liabilities assumed in a business combination in accordance with paragraph 30 of FASB Statement No. 109, Accounting for Income Taxes.

b. Further guidance on the proper procedures for writing up assets is contained

in Section 7610 of the "AICPA Technical Practice Aids."

7-1705.2 Intangible Assets

a. Intangible assets such as patents, trademarks, and franchises are referred to as “identifiable.” Other intangible assets lack specific identity. The excess amount paid for an acquired company over the sum of identifiable net assets, usually termed goodwill, is the most common unidentifiable intangible asset. The most significant distinction between “identifiable” and “unidentifiable” intangible assets is separability. Identifiable intangible assets may be acquired singly, as part of a group of assets, or as part of an entire company. Unidentifiable intangible assets are inseparable from the entity.

b. Costs should be assigned to all identifiable assets, normally based on the fair values of the individual assets; costs of identifiable assets should not be included in goodwill or any other type of unidentifiable assets (see FASB Statement No. 141 Paragraph 39). The cost of unidentifiable intangible assets is measured by the difference between the cost of the group of assets or enterprise acquired and the sum of the assigned costs of individual tangible and identifiable intangible assets acquired, less liabilities assumed.

c. The assets of the acquired company are appraised and fair values established. Usually, outside appraisers perform the appraisal. They may take several different approaches in arriving at their estimated fair values. While (1) the accounting processes prescribed by FASB Statement No. 141 require the assignment of costs to identifiable assets, and (2) GAAP prescribes recognition of the assigned cost, the auditor should not automatically conclude that the resulting costs are reasonable and reimbursable.

d. The auditor needs to evaluate the contractor's categorization of each identifiable intangible asset to determine whether or not the fair value assigned to such asset is reasonable and commensurate with economic reality or substance of the asset in review. The allowability of identified assets should be limited to fair market values subject to allocability and reasonableness tests.

7-1705.3 Allowability of Asset Valuation Write-ups

a. Contracts subject to TINA awarded after February 27, 1995 incorporate a contract clause (FAR 52-215.19) which specifically requires the contractor to notify the government of any changes in contractor ownership which would impact asset valuations. The clause also expressly requires maintenance of the records and calculation of the expense amounts which are required in order to comply with the cost principle at 31.205-52. For business combinations that use the purchase method of accounting, FAR 31.205-52 (Asset Valuation Resulting from Business Combinations) limits the amount of allowable amortization, depreciation, and cost of money to the total amount that would have been allowable had the combination never taken place. This provision became effective July 23, 1990. Simply stated, the government will not recognize for cost allowability purposes any costs resulting from the increase in the value of acquired assets (or the creation of new assets) as a result of business combinations. FAR 31.205-52 applies to contracts awarded on or after July 23, 1990. For purposes of pricing and costing contracts entered into after July 22, 1990, this FAR provision also applies to preexisting business combinations that predate the effective date of the cost principle. However, the contracting officer may need to separately address the costs of past asset write-ups on a case-by-case basis to achieve equity or to protect the government's interest in special situations (see 7-1705.3.c.).

b. An exception exists in those cases when the assigned values of noncurrent assets are adjusted downward (purchase price is less than net fair value). For contracts not subject to the April 15, 1996 revision to CAS 404, the allowability of costs will be based on the written-down amount. This is in accordance with the pre-April 15, 1996 version of CAS 404. More specifically, the pre-April 15, 1996 version of CAS 404.50(d) provides that when the fair value of assets less liabilities exceeds

the purchase price of the acquired company under the purchase method of accounting, the value otherwise assignable to tangible capital assets shall be reduced by a proportionate part of the excess. The government cannot allow costs that are not assignable to a cost accounting period under the CAS requirements. Therefore, prior book values in excess of the price paid by the contractor are unallowable. The April 15, 1996 revision to CAS 404 goes beyond the FAR concept of "no step-up" and provides "no step-up, no step-down" of asset values. Consequently, under the provisions of the revised CAS 404, the net book value of the tangible capital asset in the seller's accounting records will be used as the capitalized value of the asset for the buyer (see 8-404.2b). The contractor is responsible for maintaining the proper documentation to demonstrate that the proposed or claimed costs do not exceed the amounts calculated based on the book values of the acquired assets (but see 8-404.2b). This becomes particularly important in those business combinations when one company purchases another company and the acquired company is dissolved.

c. Auditors who encounter the following situations should advise the contracting officer that an advance agreement, while not required, may be beneficial to provide equitable treatment to both the government and the contractor and to minimize future disputes:

(1) when the government, prior to July 23, 1990, had agreed to a settlement covering a business combination which implied acceptance of such costs in the future. For example, when the government had agreed to accept an immediate credit for excess depreciation and amortization costs recognized prior to the business combination;

(2) when the acquired company had no or little government business before being acquired so that no material credit exists for excess depreciation and amortization previously recognized, and the acquiring company subsequently entered government business with the asset valuations established by the combination.

(3) when an extensive period of time has elapsed between a prior business combination and the effective date of the cost principle. A reasonable period of time may need to be considered in applying the limits of FAR 31.205-52 when the acquired company's asset values prior to the business combination are no longer available and it is not practical or cost beneficial to reconstruct these costs.

d. Gains and losses on the disposition of assets resulting from a business combination are not allowable as specified at FAR 31.205-16(a) (but see 8-409.1g.(5) and (6) for the measurement of gains and losses under the April 15, 1996 revision to CAS 409).

e. For contracts awarded on or after April 24, 1998, whether or not the contract is subject to CAS, FAR 31.205-52 allows costs calculated based on the seller's net book value (no step-up, no step-down) if the assets generated depreciation expense or cost of money charged to government contracts in the most recent accounting period prior to a business combination. If tangible capital assets did not generate depreciation expense or cost of money charged to government contracts in the most recent year, such costs calculated based on the purchase method (step-up or step-down) of accounting would be allowable.

f. The asset values determined in accordance with CAS (or GAAP) are used in the three-factor formula for distributing home office costs. Likewise, depreciation and amortization costs assigned in accordance with CAS will be included in any allocation base which normally includes such costs (e.g., the total cost input base). FAR 31.203(c) requires that the full amount of such costs be included in allocation bases so as to cause the unallowable portion of the costs to absorb a portion of overhead cost or G&A expense (see 8-410.1a(2) and 8-405.1g(1). However, on September 29, 1999, a class deviation from this requirement was issued for DoD contracts and subcontracts, effective through September 30, 2002. This deviation was extended on September 9, 2002, effective through September 30, 2005. Under this DoD deviation, the indirect costs allocable to the step-up asset value under the prior CAS 404 requirements will not be disallowed.

7-1705.4 Unallowable Costs

a. Goodwill. FAR 31.205-49 defines goodwill as an unidentifiable intangible asset. It originates from use of the purchase method of accounting for a business combination. Goodwill arises when the price paid by the acquiring company exceeds the sum of the identifiable individual assets acquired less liabilities assumed, based upon their fair values. Goodwill may arise from the acquisition of a company as a whole or in part. Any costs for amortization, expensing, write-off, or write-down of goodwill (however represented) are unallowable.

b. Cost of Money. The cost of money resulting from including goodwill (however represented) in the facilities capital employed base is unallowable (see FAR 31.205-10(a)(5)).

7-1705.5 Summary of Audit Guidelines for Write-ups

a. For contracts awarded after July 22, 1990, the auditor should verify that contracts do not receive increased costs flowing from asset revaluation resulting from business combinations. This would also apply to preexisting business combinations that predate the contracts being entered into. The auditor may have to advise the contracting officer of the need to separately address the costs of past asset write-ups on a case-by-case basis to achieve equity or to protect the government's interest in special situations.

b. For contracts awarded on or after April 15, 1996, the auditor should verify whether the contracts are subject to the revised CAS 404 and 409, effective April 15, 1996 (8-404.b and 8-409.b). If the revised CAS 404 and 409 apply, the auditor should verify whether the acquired tangible capital assets generated depreciation or cost of money charges on Federal government contracts or subcontracts negotiated on the basis of cost during the most recent cost accounting period. For tangible capital assets that generated such depreciation expense or cost of money charges, no write-up and no write-down of asset values is permitted and no gain or loss is recognized on asset disposition. For tangible capital assets that did not generate such depreciation or cost of money charges, asset values are written-up or written-down in accordance with CAS 404.50(d)(2). However, tangible capital assets meeting the requirements of CAS 404.50(d)(2) must still comply with the requirements of FAR 31.205-10, 31.205-11, 31-205-16, and 31.205-52 (i.e., costs resulting from asset write-ups are unallowable).

c. For contracts awarded on or after April 24, 1998, whether or not the contract is subject to CAS, the allowable depreciation and cost of money would be based on capitalized asset values measured in accordance with CAS 404.50(d). (See 8-404.2.b and 8-409.2.b.)

7-1706 Novation Agreements

a. A successor in interest to a government contract usually evolves from a change in the ownership of a contractor organization. The successor in interest is recognized by a novation agreement executed by (1) the contractor (transferor), (2) the successor in interest (transferee), and (3) the government. By the novation agreement, among other things, the transferor guarantees performance of the contract, the transferee assumes all obligations under the contract, and the government recognizes the transfer of the contract and related assets (FAR 42.1201). Novation agreements are entered into for all executory contracts transferred to a successor in interest.

b. The transfer of a government contract is prohibited by law (41 U.S.C. 15). However, FAR 42.1204(a) states: "The government may, when in its interest, recognize a third party as the successor in interest to a government contract when the third party's interest in the contract arises out of the transfer of (1) all the contractor's assets or (2) the entire portion of the assets involved in performing the contract." Examples include, but are not limited to:

(1) Sale of the assets with a provision for assuming liabilities.

(2) Transfer of the assets pursuant to merger or consolidation of a corporation.

(3) Incorporation of a proprietorship or partnership or formation of a partnership.

c. When it is in the government's interest not to concur in the transfer of a contract from one company to another company, the original contractor remains under contractual obligation to the government, and the contract may be terminated if the original contractor does not perform (see FAR 42.1204(c)).

d. When a contractor requests the government to recognize a successor in interest, the contractor is required to submit a signed novation agreement. The form of the novation agreement and the conditions for its use are prescribed in FAR Subpart 42.12.

e. The standard novation agreement provides in part that "The Transferor and the Transferee agree that the government is not obligated to pay or reimburse either of them for, or otherwise give effect to, any costs, taxes, or other expenses, or any related increases, directly or indirectly arising out of or resulting from the transfer or this Agreement, other than the government in the absence of this transfer or Agreement would have been obligated to pay or reimburse under the terms of the contracts" (see paragraph (b)(7) of the standard novation agreement at FAR 42.1204(i)). Auditors should be aware that the cited provision is not limited to professional services, taxes, and corporate expenses directly connected with the change in ownership. For novated contracts, it bars any increase in contract costs that would otherwise not have occurred. This applies not only to total cost of performance but to any element of cost. The Armed Services Board of Contract Appeals barred an increase in depreciation resulting from a revaluation of assets by the new owners (LTV Aerospace Corporation, ASBCA No. 11161, 67-2 BCA para. 6406). In that case, the Board also rejected a contention that the claim was proper as an offset for "savings" resulting from decreases in other cost categories such as reduced state income taxes resulting from increased depreciation. The "savings" were not costs under the contract because they were never incurred by the contractor.

f. Auditors need to review each novation agreement to determine its accounting impact on the applicable contracts, the concurrently running contracts, and those contracts entered into subsequent to the agreement.

g. Pending the execution of a novation agreement, auditors should consult with the ACO on matters such as the appropriate recognition of the transferee and transferor for contract costing and payment purposes.

7-1707 Organization and Reorganization Costs

a. Expenditures made in connection with planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions, are unallowable under FAR 31.205-27, Organization Costs (see Dynalectron Corporation, ASBCA 20240, 77-2 BCA 12835). Such expenditures include, but are not limited to, incorporation fees and costs of attorneys, accountants, brokers, promoters and organizers, management consultants, and investment counselors, whether or not they are employees of the company. This would also include costs related to changes in the financial structure which may result from divestitures or the establishment of joint ventures or wholly-owned subsidiaries. In establishing the coverage at FAR 31.205-27, the Cost Principles Committee relied on the following definition of an organization and reorganization and the costs thereof:

(1) A major change in the financial structure of a corporation or a group of associated corporations resulting in alterations in the rights and interest of security holders; a recapitalization, merger, or consolidation.

(2) Any costs incurred in establishing a corporation or other form of organization; as, incorporation, legal and accounting fees, promotional costs incident to the sale of securities, security-qualification expense, and printing of stock certificates.

b. In the event a contractor creates or acquires a new segment or business unit through an acquisition or reorganization, the auditor should review the activity associated with the transaction to determine if any unallowable or unallocable

costs are assigned to government contracts. These activities are often performed by an in-house business planning group, an acquisition and divestiture committee, and by the corporate legal and accounting departments. The auditor should review any available documentation to identify activities and associated costs which are directly incident to establishing or altering the contractor's financial structure. Many times the employees involved in these activities do not maintain adequate time records to identify and support their effort expended on reorganizations and related work. The auditor should ensure that the contractor implements the necessary policy and procedures to properly identify and account for these activities.

c. Normal recurring expenditures associated with internal reorganizations of contractor segments and divisions are generally allowable costs to the extent they are reasonable and allocable. Such expenditures may be incurred for business planning and forecasting, developing policies and procedures, preparing a CAS disclosure statement, establishing an accounting system, etc.

7-1708 Costs Associated With Resisting Change in Ownership (Golden Parachutes and Golden Handcuffs)

7-1708.1 General Allowability

a. For contracts awarded prior to April 4, 1988, contractor expenditures to resist a takeover should be disapproved in accordance with the provisions of both FAR 31.205-27, "Organization Costs," and FAR 31.205-28, "Other Business Expenses." In addition, the auditor should:

(1) Be aware that such costs do not meet the criteria for allocability stated in FAR 31.201-4 (i.e., the costs are not incurred specifically for a government contract nor do they benefit government work).

(2) Make every effort to have the contractor segregate its expenditures to effect or resist a business combination as they are being incurred.

b. For contracts awarded on or after April 4, 1988, the costs incurred by a contractor in connection with successfully or unsuccessfully resisting a merger or takeover are expressly unallowable per FAR 31.205-27(a), and must be segregated as unallowable costs per FAR 31.201-6.

7-1708.2 Abnormal Executive Severance Pay (Golden Parachutes)

In order to discourage a hostile takeover attempt, some companies have instituted extraordinary arrangements with key employees to provide very large termination benefits to be paid only in the event of a merger or loss of control and the subsequent dismissal, termination, or departure of the executive. These arrangements have been referred to as "Golden Parachutes" because they provide extremely lucrative financial arrangements for the executives in those circumstances. See 7-2107.8 for a discussion of the allowability of these costs.

7-1708.3 Special Compensation for Retaining an Employee (Golden Handcuffs)

Special compensation which is contingent upon the employee remaining with the contractor for a specified period of time is commonly called "golden handcuffs," and is expressly unallowable per FAR 31.205-6(l), "Compensation incidental to business acquisitions." With respect to the FAR provision, it is important to note that the disallowance of costs is linked with the requirement for the employee to remain with the company. For example, assume an individual was performing a job normally paid and objectively worth $50,000 per year, but for good reason, (e.g., to help the company through a rough financial period) accepted and was paid only $40,000 per year. If the new owners immediately raise the individual's salary to $50,000, this would not be considered a "golden handcuff" unless the pay raise is granted on a condition that the individual would remain with the company for a specified period of time.

7-1709 Adjustment of Pension Costs

a. In the event of a business combination, the DCAA auditor cognizant of the selling contractor, in consultation with the DCMA insurance/pension specialist, will

determine whether an adjustment of pension costs is required in accordance with CAS 413.50(c)(12). In making this determination, the asset purchase/sales agreement should be reviewed immediately following the business combination. If an adjustment of pension cost is warranted, the auditor should request the ACO to initiate a special CIPR. Refer to audit guidance contained in 7-605.2 (f) and 8-413.3 for additional guidance.

b. The FAO cognizant of the selling contractor should also verify the amount of pension assets and liabilities transferred to the acquiring contractor. Actuarial reports, bank wire transfers and trust statements for the pension plan document the amount of assets and liabilities transferred. The FAO should confirm in writing the amounts transferred with the DCAA office cognizant of the acquiring contractor.

7-1710 Organization and Reorganization References

a. Access to Records 1-504
b. Advance Agreements FAR 31.109
c. Asset Valuation Resulting from Business Combinations FAR 31.205-52
d. Business Combinations FASB Statement No. 141
e. Capital Investment 14-602
f. Capital Tangible Assets CAS 404
g. CAS Disclosure Statement 48 CFR 9903.2
h. Cash Disbursements 14-305.2f
i. CAS Impact Statement 48 CFR 9903.3
j. Compensation FAR 31.205-6
k. Consultants FAR 31.205-33 & 37.203
l. Cost of money FAR 31.205-10; CAS 414
m. Depreciation FAR 31.205-11; CAS 409
n. Economic planning FAR 31.205-12
o. Gains and losses on assets FAR 31.205-16
p. Goodwill FAR 31.205-49
q. Insurance FAR 31.205-19; CAS 416
r. Intangible assets FASB Statement No. 142
s. Labor relations costs FAR 31.205-21
t. Pensions FAR 31.205-6(j); CAS 412 & 413
u. Plant Rearrangement 9-703.9
v. Records Destroyed 1-506
w. Sale and Leaseback 9-703.11
x. SEC Current Report 3-1S1 (Form 8k)
y. Taxes FAR 31.205-41

7-1800 Section 18 --- Joint Ventures, Teaming Arrangements, and Special Business Units (SBUs)

7-1801 Introduction

a. This section provides guidance for audit evaluation of joint ventures, teaming arrangements, and special business units (SBUs).

b. The form of business organization chosen by the contractor to carry on its business or to bid on government contracts significantly affects contractor costs and income taxes. Eligibility for award of a government contract may be directly linked to the form of business organization under which a contractor elects to bid. Concurrently, the form of business organization will have a significant bearing on determining the allowability and allocability of costs incurred under government contracts. Therefore, in reviewing a contractor's business organization, the auditor must consider the related business circumstances and the contractor's compliance with generally accepted accounting principles, FAR, and CAS. An understanding of the applicable Internal Revenue Service Regulations and provisions of both Federal law and state law would also be beneficial in many instances.

7-1802 General Terms and Definitions

a. Corporation. A business organization of one or more persons, partnerships, associations, or corporations chartered by the state for the purpose of conducting profit making endeavors with the objective of dividing the gains. A corporation is a separate legal entity with the following usual characteristics: continuity of existence, centralized management, liability limited to corporate assets, and free transferability of interest. A corporation may perform any business action that can be performed by a natural person.

b. Joint Venture.

(1) An enterprise owned and operated by two or more businesses or individuals as a separate entity (not a subsidiary) for the mutual benefit of the members of the group. Joint ventures possess the characteristics of joint control; e.g., joint property, joint liability for losses and expenses, and joint participation in profits. Joint ventures can be either incorporated or unincorporated. The incorporated joint venture involves the issuance of stock and is most common on large construction type contracts. These joint ventures possess the typical characteristics of a corporation. The unincorporated joint venture can be a partnership or teaming arrangement between two or more corporations usually involved in large research and development and/or major weapons systems contracts. Usually in this type of joint venture, the joint venture is the contracting entity and is designated to act as the prime contractor.

(2) Joint venture ownership seldom changes, and the stock of an incorporated joint venture is normally not traded publicly. Furthermore, under the usual arrangement: (a) each investor participates, directly or indirectly, in the overall management of the joint venture (i.e., joint venturers usually have an interest or relationship in the venture other than as passive investors); (b) significant influence of each of the investors is presumed to be present; and (c) one investor does not have control by direct or indirect ownership of a majority voting interest (otherwise the venture is likely to be a subsidiary of the controlling investor).

c. Teaming Arrangement. An arrangement between two or more companies, either as a partnership or joint venture, to perform on a specific contract. The team itself may be designated to act as the prime contractor; or one of the team members may be designated to act as the prime contractor, and the other member(s) designated to act as subcontractors. (See FAR Subpart 9.6.) When the characteristics of joint control (i.e., joint property, joint liability for losses and expenses, and joint participation in profits) are evident, then the teaming arrangement is a joint venture. When these characteristics are not present then the arrangement may more closely resemble that of a prime contractor/subcontractor.

d. Partnership. An ordinary partnership occurs when two or more entities (persons) combine capital and/or services to carry on

a business for profit. From a legal standpoint, it is a group of separate persons.

e. Cooperative Research Consortiums. A cooperative research consortium is a partnership, joint venture, or corporation organized pursuant to the 1984 National Cooperative Research Act. Research consortiums involve collaborations among competitors and are usually formed to explore specific research areas. Unlike other business entities discussed in this section, cooperative research consortiums are not formed to bid on government contracts. See 7-2115 for additional guidance on cooperative research consortiums.

f. Special Business Unit (SBU). SBU is the term used within CAM and other Agency guidance to describe business organizations established by a single contractor to (a) support a single contract, program, or product line, (b) limit financial, tax, or legal liability, and/or (c) gain a technical or cost advantage. For purposes of this guidance, an SBU may be a wholly-owned subsidiary, a corporate division, or a joint venture/partnership composed of segments of the contractor.

g. Subsidiary. An entity controlled, directly or indirectly, by another entity. Control is usually conditioned upon ownership of a majority of the outstanding voting stock. It may also exist, however, with less than a majority of the outstanding voting stock under certain conditions (e.g., there is a contract, lease, agreement with other stockholders, or court decree).

7-1803 Characteristics of a Joint Venture

a. An incorporated joint venture normally has characteristics common to a corporation (see 7-1802a.). It is a separate legal entity and acts as a contracting party.

b. An unincorporated joint venture usually is either a partnership or a teaming arrangement and most often has (1) few or no employees hired and paid by the joint venture, (2) little or no assets or separate facilities, (3) no separate financial statements, and (4) little or no G&A, B&P, or material handling expenses. All contract work is performed by the venturing organizations or other subcontractors. Employees are paid by their respective companies. The terms of the formation, operation, and dissolution of the venture are usually specified in a written agreement between the venturing organizations (see 7-1807a.).

7-1804 Characteristics of SBUs

a. An SBU is a segment of the establishing contractor since the SBU is either a subdivision of that contractor or is controlled by that contractor.

(1) Some SBUs have employees hired and paid by the SBU who actually perform the required contract effort. These SBUs may also have their own assets and liabilities and have profit and loss responsibility. They are usually reportable segments for financial and tax purposes. These SBUs are often engaged in foreign military sales or direct commercial sales to foreign governments. These SBUs are usually formed to limit tax and /or legal liability.

(2) Other SBUs are more like joint ventures and teaming arrangements. These business organizations have no employees and subcontract virtually all (over 90 percent) contract effort to other contractor division s and/or outside subcontractor(s). Often these SBUs have little or no assets. This type of SBU may have been formed to gain competitive, cost, and/or technical advantages.

b. The audit concern is that any cost advantage be based on valid cost allocation practices. Basically, there are two types of cost advantages that SBUs can attain. The first type results from the fact that an SBU is a specialized contracting entity supported by one or more established contractor entities. The second type results from cost allocation practices that enable an SBU contract to significantly reduce, or altogether avoid, the amount of material overhead and G&A that the contractor would normally have to allocate to its subcontracts and/or interdivisional work. If the cost allocation practices cause a significantly different allocation to a SBU contract than would have been allocated to the same contract if issued directly to the contractor's operating segment, the cost allocation practices may be inequitable and/or CAS noncompliant.

7-1805 Audit Considerations

a. The joint venture and teaming arrangement guidance in this section has been written to specifically cover unincorporated joint ventures, and may not apply to incorporated joint ventures.

b. There are a number of audit issues and concerns related to the formation, organization, and operation of joint ventures, teaming arrangements, and SBUs. These types of business organizations can have a material impact on the contractor's existing organizations and government business. The creation of an SBU may change our prior assessment of internal controls and may cause increased costs on contracts at existing contractor segments.

c. The impact, however, is not always adverse, and the creation of joint ventures and SBUs may be proper and acceptable. A number of contractors have established joint ventures in response to an RFP requirement for contractor teaming arrangements. In these procurements it is the government's acquisition strategy to have two or more contractors team together to jointly design, develop, and test some type of new technology with the intent to qualify multiple contractor sources for future production. This type of acquisition strategy is most popular on major weapon system procurements. Normally, these teaming arrangements have the characteristics of joint and equal control where neither contractor possesses a majority ownership nor exercises management control. Similarly, some contractors have established wholly-owned subsidiaries or divisions for FMS contracting purposes. Many of these SBUs have been created to limit tax or legal liability.

d. There are also a number of joint ventures and SBUs that may present problems which the auditor and CAC/CHOA should fully disclose to the contracting officer, DACO, CACO, and DCE to aid in making their decisions in relation to contracting with the joint venture or SBU. This is particularly important when the performance of a joint venture or SBU contract would cause increased costs on other government contracts or when the changes in accounting practices associated with the contract have not been fully disclosed. After award of a contract to such a joint venture or SBU, the auditor should monitor the costs allocated to the SBU to assure that it absorbs an equitable share of costs.

e. In developing audit steps to disclose and report on these situations, consider both the form and substance of the business unit. In reviewing the form and substance of the business unit, consider the following:

(1) Is the joint venture or SBU a business segment? (see 7-1806.)

(2) What is the actual relationship between the venturing organizations? (see 7-1807.)

(3) Is the joint venture/SBU cost accounting and tax treatment consistent with the form and substance of the business organization? (see 7-1808 and 7-1809.)

(4) Does the joint venture/SBU accounting result in equitable cost allocations between and among the business organizations/segments? (see 7-1810.)

(5) Does the joint venture/SBU have a cost impact on the existing contracts of the venturing/parent organizations, and if so, has a change in cost accounting practice occurred? (see 7-1811.)

7-1806 Characteristics of a Legitimate Business Unit/ Segment

a. When reviewing the accounting aspects of a contractor's business organization, the identification of the organization as a segment or business unit is important for the following reasons:

(1) CAS consistently uses the terms "segment" and "business unit" to present its accounting guidance on business organizations.

(2) Various financial accounting pronouncements, such as those dealing with consolidated reporting, also use the term "business segment" to present GAAP that applies to business organizations in general. (Note that the CAS and FASB definitions for "segment" are not the same.) The CAS/FAR definition is the relevant definition for government cost accounting purposes.

(3) Entities that do not satisfy the basic criteria for a segment or business unit are actually an undivided part of a contractor

business unit. Therefore, separate allocations to such an SBU would often be in noncompliance with those provisions of CAS (e.g., 402, 403, 410, 418, and 420) which deal with the consistency and fragmentation of allocation bases. (See 7-1810.)

b. The terms "segment" and "business unit" are defined for CAS purposes in FAR 2.101. A CAS segment is "one of two or more divisions, product departments, plants, or other subdivisions reporting directly to a home office, usually identified with responsibility for profit and/or producing a product or service." A CAS segment may include a GOCO facility, or a joint venture or subsidiary in which the organization exercises control. CAS does not define control nor provide criteria for determining whether an organization exercises control. A business unit, in turn, is any segment of an organization which is not further divided into segments.

7-1807 Relationship Between Business Organizations

The form and substance of a contractor's business organization can significantly influence the allowability and allocability of costs incurred under government contracts. Determine not only the form of the business organization but the actual relationship (substance) between the venturing contractors. Several criteria and appropriate review procedures are presented below. Normally no one factor should be the sole determinant of whether the relationship is a joint venture or more closely resembles a prime contractor/subcontractor relationship. The allocation of costs should reflect the causal/beneficial relationships between and among the venture partners and other segments/home offices of the contractor.

a. Review of Joint Venture Agreements

(1) FAR 9.603 requires contractor joint ventures and teaming arrangements to identify and disclose the arrangements in an offer or, for arrangements entered into after submission of an offer, before the arrangement becomes effective. This is normally done in a written agreement between the participating contractors. An agreement will normally contain and/or explain:

(a) the name of the venture;

(b) the customer and solicitation number;

(c) the names of the participants;

(d) any limitations on the powers and rights of the participants;

(e) the contributions that each participant is required to make with regard to the venture's capital, personnel, proposal preparation, etc.;

(f) anticipated subcontracts;

(g) funding requirements;

(h) responsibilities for record keeping and for the preparation of reports and invoices;

(i) the designated management;

(j) limitation of liabilities;

(k) term of venture and dissolution agreements;

(l) responsibilities for and restrictions on royalties, patents, copyrights, and property rights arising from venture operations;

(m) the resolution of disputes among the venturers;

(n) covenants on how litigation costs will be borne by the participants;

(o) which state's laws will govern the venture;

(p) the filings or disclosures required by the state, FAR, etc.;

(q) any technology transfer agreements; and

(r) any cost/profit sharing agreements.

(2) Review the written agreement to help determine the management, financial, and technical responsibilities of each contractor. In addition, review the joint venture/teaming arrangement organization chart(s) and policies and procedures. This information can be useful in determining if the characteristics of joint control and management are present or if one contractor seems to possess the control and management characteristics of a prime contractor.

b. Ascertain each venturers responsibility for the financial and technical management of the joint venture. Determine the composition of the joint venture management team, the location of the joint venture program office, the procedures for preparing the joint venture financial statements, tax returns, and government billings and technical reports.

Also review each venturer's responsibility and role in the preparation of the joint venture proposal. Ascertain each venturer's responsibilities for outside subcontractor selection and material purchasing. The composition of the key personnel to the joint venture should also be analyzed. When considered together this information will help determine the actual relationship between the venturers. It will also help determine if one venturer exercises control over the joint venture.

c. Review the composition of the joint venture or teaming arrangement capital and equity to help determine if one of the venturers exercises ownership control. Analyze any cost and revenue sharing agreements and asset contributions.

d. Review the technical relationship between the venturers by reviewing the written agreement, any technical exchange agreements, the cost and technical proposals, the contract and/or subcontract statements of work, and other relevant documentation. Determine the assignment of technical responsibilities to each venturer, the integration of work products between the venturers, and the technical areas of expertise of each venturer. The responsibilities of each organization for technical interface with the government can also help determine the technical relationship between the venturers.

e. Discuss the joint venture/teaming arrangement with the cognizant DCAA offices for the other venturing contractors to help ensure consistent audit treatment. Coordinate with the other cognizant DCAA offices to establish responsibilities for audits of forward pricing proposals, public vouchers, progress payments, etc., to request appropriate assist audits, and to ensure adequate audit coverage of joint venture costs. See 6-800 and 9-100 for additional guidance on audit coordination between DCAA offices and for requesting assist audits.

7-1808 Accounting Considerations

7-1808.1 Accounting Considerations for Joint Ventures

a. General. A joint venture, proposed and established as a separate business entity, should have its own set of books and supporting documentation sufficient for an audit trail. Transactions should be recorded consistent with the joint venture agreement (7-1807a.), and care must be taken to ensure that the joint venture bears its equitable share of the costs. For audit guidance on the general implications of FAR and CAS in the review of joint ventures and SBUs, see 7-1810.

b. Incorporated Joint Ventures. Investors, in most circumstances, should use the equity method to account for incorporated joint ventures. The generally accepted accounting principles (GAAP) relating to this method of accounting for investments in joint ventures are contained in APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock," and, to a lesser extent, in APB Opinion No. 23, "Accounting for Income Taxes-Special Areas." Paragraph 16 of APB 18 concludes that investments in common stock of incorporated joint ventures should be accounted for by the equity method, regardless of the percentage of stock held, to reflect the underlying nature of their investment in such ventures. The uncommon circumstances under which the cost method of accounting for incorporated joint ventures should be used in lieu of the equity method are noted in paragraph 16 of APB Opinion No. 18.

c. Unincorporated Joint Ventures. The provisions of APB Opinion No. 18 have generally been interpreted as being applicable to unincorporated joint ventures as well as incorporated joint ventures. Therefore, in most circumstances when the investment in an unincorporated joint venture is material, the equity method should also be used to account for the investment.

d. Joint Venture Accounting as a Partnership. If a joint venture elects to be treated as a partnership, or is required by either the Federal tax code or any state's partnership laws to be treated as a partnership, then the joint venture should (1) adopt accounting practices that are consistent with the single entity concept, and (2) maintain a complete set of books and records.

e. See 7-1807 for criteria to help determine the actual relationship between the venturing contractors.

7-1808.2 Accounting Considerations for Teaming Arrangements

a. The accounting for teaming arrangements should be consistent with the form of business organization that the teaming contractors have agreed to and disclosed in their proposal(s). For example, if the agreed-to arrangement is in the form of a joint venture, then this should be disclosed in the proposal(s) and the accounting principles applicable to a joint venture should be followed. FAR 9.603 requires contractors to fully disclose all teaming arrangements in their offers. If an arrangement is entered into after submitting an offer, then disclosure is required before the arrangement becomes effective.

b. When the characteristics of joint control (i.e., joint property, joint liability for losses and expenses, and joint participation in profits) are evident, then the business arrangement is a joint venture. If the characteristics of joint control are not evident, then the terms of the business arrangement should be reviewed to see if a prime contractor/subcontractor relationship exists between the parties. Note, however, that a disclaimer of a joint venture arrangement in itself does not preclude an arrangement from being classified as a joint venture if it possesses the characteristics of a joint venture. See 7-1807 for criteria to determine the actual relationship between the contractor organizations.

7-1808.3 Accounting Considerations for SBUs

A Special Business Unit or SBU, as explained in 7-1802f., is DCAA's term to describe a contractor subsidiary, division, or other form of business organization established to accomplish certain specific tasks or to gain a competitive advantage. It is not a distinct entity form; therefore, the accounting for an SBU should follow the principles established for the actual entity involved and be consistent with the contractor's disclosed accounting practices.

7-1809 Joint Venture, Teaming Arrangement, and SBU Federal Taxes

7-1809.1 Tax Classification and Definitions of Organizations

a. General. The classification and definitions of organizations for Federal tax purposes are contained in the regulations of the Internal Revenue Service (26 CFR 301.7701-1 et seq.). Except for organizations of professional persons, local law will have little bearing in the determination of an entity's classification for tax purposes. The tax and common business law definitions for the various types of business organizations are usually different. Some examples of these differences are noted below.

b. Corporation. The term "corporation" as defined in the CFR is not limited to the entity commonly known as a corporation (see 7-1802a.); it includes an association, a trust classified as an association due to the nature of its activities, a joint-stock company, an insurance company, and certain kinds of partnerships.

c. Partnership.

(1) The term "partnership" is also broadly defined in the CFR to encompass just about all types of unincorporated organizations including most forms of syndicates, groups, pools, and joint ventures. In other words, if a legal business entity does not constitute a trust, estate, or corporation for tax purposes, then it is likely to be considered a partnership. Further note that the tax status of a partnership is not affected by the fact that a corporation may be one of the partners, or that local law does not permit a corporation to be a partner.

(2) Notwithstanding the above, DoD contractors have established several forms of unincorporated joint ventures and joint venture teaming arrangements that they do not consider to be partnerships for tax purposes.

d. Limited Partnership. A limited partnership, depending upon its specific characteristics, is classified in the CFR as either

an ordinary partnership or as an association taxable as a corporation.

e. Association. Section 301.7701-2 of the CFR defines an association as a corporation if it has certain characteristics, including: (1) associates, (2) free transferability of interest, (3) an objective of carrying on a business and distributing profits, (4) liability for debt limited to corporate property, (5) continuity of life (i.e., a going concern), and (6) central management.

7-1809.2 Review of Tax Returns

a. Review the joint venture, teaming arrangement, or SBU tax returns and supporting records to determine, confirm, or gain additional insight into the type and nature of the contracting entity. Tax information can answer questions on ownership and control and on whether a given organization exists as a separate legal business entity or as a component of a contractor's existing business entity. When reviewing a joint venture or teaming arrangement that may or should be treated as a partnership for tax purposes, request Schedules K and K-1, supporting Partnership Return Form 1065. These schedules address the apportionment of income, credits, deductions, etc. to the individual partners (i.e., joint venturer's/team members). They also identify the individual partners and contain other information relating to the assessment of costs, degree of control, ownership of capital, percentages of profit and loss sharing, and credits.

b. General guidance on the review of contractor tax returns is provided in 3-1S2, and brief descriptions of some of the applicable tax forms are also presented in 3-1S2.

7-1810 FAR and CAS Cost Allocation Considerations

7-1810.1 FAR Compliance

a. General. The FAR does not specifically address a joint venture as a party in the procurement of supplies and services under government contracts. It is therefore necessary to understand the purpose for and characteristics of a joint venture when reviewing the venture in terms of the FAR, specifically the FAR cost principles on allowable costs.

b. Material/Service Costs and Venture Control. When one of the venture participants exercises majority control over the joint venture, FAR 31.205-26(e) specifically provides that the transfer of material costs or service costs from any of that company's segments to the joint venture should be on the basis of cost incurred, unless competitive or catalog prices are involved. In the event that the venture members appear to be equal participants, the provisions of FAR 31.205-26(e) still apply, if the auditor can determine that one of the members actually exercises predominant control over the venture. To help make this determination the auditor should look at the venture agreements to ascertain if any member has significant risk or underwriting responsibility in disproportion to the others.

7-1810.2 CAS Disclosure Statements.

a. General. Any contractor which, together with its segments, receives net awards of CAS-covered negotiated government contracts totaling $50 million or more in its most recent cost accounting period must submit a CAS Disclosure Statement (48 CFR 9903.202-1(b)). Any business unit that is selected to receive a CAS-covered negotiated government contract or subcontract of $50 million or more is also required to submit a Disclosure Statement. (see 8-103.8)

b. Joint ventures are composed of two or more contractors each of which may have already filed a Disclosure Statement as a result of having obtained other government contracts. Review the characteristics of the joint venture to determine if the joint venture meets the definition of a CAS segment.

c. The need for a joint venture CAS Disclosure Statement depends upon the characteristics of the venture itself. The determination must be made on a case-by-case basis. Where the joint venture is the entity actually performing the contract, has the responsibility for profit and/or producing a product or service, and has certain characteristics of ownership or control, a Disclosure Statement should be required.

Where the venture merely unites the efforts of two contractors performing separate and distinct portions of the contract with little or no technical interface, separate joint venture disclosure may not be required. Where doubt exists, discuss the circumstances with the contracting officer.

7-1810.3 Cost Allocation

a. There is no one cost allocation model which covers contracts issued to all joint ventures, teaming arrangements, and SBUs. The range includes everything from models where all costs are incurred at the contracting entity to models where no costs are incurred at the contracting entity. The former model is a normal prime contracting scenario and the later is descriptive of SBUs which have no employees or assets of their own.

b. Many contractors either have their SBUs "borrow" employees from other segments of the contractor or have the other segments perform the tasks normally performed by the prime contractor in place of the SBU. In either case, the arrangement may create a home office at the segment providing the services to the SBU. A home office provides management services or supervision to two or more segments. For CAS-covered contractors, the home office costs must be disclosed and be compliant with CAS 410.50(h) and CAS 403. The tasks performed by the home office for the SBU may include a wide range of functions; e.g., general management, bid and proposal, independent research and development, selling, contract administration, material handling, procurement, computer services, personnel services, etc. When a segment begins to perform indirect functions for another segment it may present new labor charging and timekeeping problems requiring new training and internal controls.

c. In extreme cases, SBUs have no employees or assets. All the deliverable services and products are designed, manufactured, assembled, and provided by operating segments of the contractor. These operating segments only transfer the costs to the SBU for billing purposes. All G&A/B&P/IR&D, any specifically identifiable contract management functions, and any other indirect costs are performed by one or more of the contractor's other segments, making those segments home offices which must allocate the costs to the SBU.

d. When residual home office expenses are allocated using the three factor formula, CAS 403 requires that inter-segment sales be claimed at the segment which produced the contract deliverable product or service. When determining the sales factor to be used in the three factor allocation for residual expenses at a home office or a group home office, CAS 403.50(c)(1)(ii) requires that each segment in the allocation grouping include inter-segment sales in its sales total and then reduce its sales total by the amount of purchases from other segments in the allocation grouping.

e. Allocation of Home Office Expenses to Joint Ventures and Teaming Arrangements.

(1) General. Most of the joint ventures or teaming arrangements encountered to date have been established as CAS 403 segments with the venturing companies acting as intermediate home offices for their share of the venture costs. Such arrangements usually involve the adoption of a "special" method of allocating residual home office expenses wherein each venturer allocates a portion of its residual expenses to their portion of the joint venture costs. Notwithstanding this background on the typical arrangement, follow the guidance below in the review of home office expenses relative to joint ventures.

(2) If the joint venture or teaming arrangement is considered a segment in accordance with the definition of CAS 403 (see a & b above), the auditor needs to ensure that each of the venturing companies (a) identifies and directly allocates those home office expenses that were specifically incurred in support of the joint venture, (b) separately allocates to the joint venture its share of home office support expenses from any homogeneous pools, and (c) adopts one of the following practices for the allocation of residual expenses:

(a) The venturer’s can request a special allocation of the residual expenses in accordance with the criteria in CAS 403.50(d)(1).

(b) The majority or controlling contractor can treat the joint venture as a segment of its company, and include the entire operations of the venture in its formula for allocating residual expenses.

(c) The minority contractor may also allocate its company's residual expenses to joint venture, but is not required to.

(3) The joint ventures and teaming arrangements that have not been formed as separate CAS 403 segments (see a & b above) generally do not have, and would not be expected to have, significant assets or payrolls (elements of the three factor formula for allocating residual expenses). Home office expenses are allocated to the contracts of these joint ventures in the same manner that the venturing companies allocate these expenses to their other contract work.

f. CAS 410.50(d) requires that the cost input base used to allocate the G&A expense pool include all significant elements of that cost input which represent the total activity of the business unit. Only in instances where a particular final cost objective in relation to other final cost objectives receives significantly more or less benefit from G&A expense can the contractor deviate from this requirement. All special allocations of this nature must be handled in accordance with CAS 410.50(j). Such special allocations may be appropriate in unusual circumstances that are not expected to recur. To the extent that subcontracts or any other significant element of cost input, representative of the total activity of the unit, are excluded from the base, a noncompliance occurs.

g. CAS 420.50(f)(2) requires that the cost input base used to allocate IR&D/B&P costs to all final cost objectives be the same as the G&A allocation base. As with G&A above: (a) only in instances where a particular final cost objective in relation to other final cost objectives receives significantly more or less benefit from IR&D/B&P costs can the contractor deviate from this requirement, and (b) to the extent that a significant element of cost input is excluded from the base, a noncompliance occurs.

h. CAS 418.50(d)(2) states that a material cost base is appropriate if the activity being managed or supervised is a material-related activity. Upon selection of a material cost base, all significant elements shall be included in that allocation base.

i. When reviewing joint ventures or teaming arrangements that have been established as a separate business entity and which have a CAS-covered contract the auditor should:

(1) Treat the venture as a separate contractor segment, even if the venture has few, if any, assets or employees, and no up-front investment. See 7-1806 for further guidance relating to the determination of separate business units/segments.

(2) Ensure that all of the costs that should be allocated to the venture are appropriately allocated to the venture in accordance with the provisions of CAS. (G&A and IR&D/B&P, for example, should be allocated to the venture according to the provisions of CAS 403, 410, and 420.)

j. When reviewing joint ventures and teaming arrangements that have not been established as a separate business entity, the auditor should:

(1) Determine the reasons why the venture is not being treated as a separate entity or CAS business unit/segment. For example, do the venturer's claim that a separate segment does not exist because (a) the venture has no assets, employees, or up-front investment, and/or (b) the cost impact of establishing the venture as a separate entity is not significant enough considering the extra administrative costs involved?

(2) Determine how the venture and venturing companies are being treated and accounted for. For example, are the venturing companies being treated as independent contractors (vs. subcontractors to the joint venture)?

(3) Develop a position based on appropriate consideration of (a) the CAS requirements, (b) the principle of "substance over form," (c) materiality of the cost impact associated with establishing a separate entity, and (d) the intent of the contracting officer. If a preliminary position is developed which substantially differs from, or conflicts with, the intent of the contracting officer, elevate this matter through normal channels to the attention of the Headquarters Accounting and Cost Principles Division.

(4) Meet with the contracting officer and/or administrative contracting officer to (a) discuss your findings and the contracting officer's position with respect to the arrangement, and (b) work toward changing any unsuitably proposed or established joint ventures.

(5) Communicate any adverse impact associated with the joint venture arrangement (i.e., CAS noncompliance or accounting inconsistency) to the ACO, cognizant PCO, and other PCOs affected by the arrangement, and continue to closely monitor the arrangement for such an impact.

7-1811 Changes in Cost Accounting Practices

a. Basic Audit Requirement. Once a CAS-covered joint venture or SBU is established, and there are no apparent CAS noncompliances associated with the allocation of costs, the auditor must next determine whether the SBU organization itself has impacted the costs on any existing company contracts, and if so, whether a change in cost accounting practice occurred. Each organizational change must be evaluated separately to determine whether a change in cost accounting practice has occurred. Specific criteria for making these determinations are provided in 48 CFR 9903.302 and 8-303.3, and are restated in part below.

b. Basis for Audit Determination. The CAS definition for a change in cost accounting practice is presented in 48 CFR 9903.302-2. The CAS Board's discussion on when an organizational change may be considered a change in cost accounting practice is presented in Part II, Preamble J, of the Appendix to FAR loose-leaf edition. As part of this discussion, the Board stated that while organizational changes by themselves are not changes in cost accounting practices, such changes may cause a change in a contractor's cost accounting practices. The Board further stated that the decision as to whether there is a change in cost accounting practice should be made through an analysis of the circumstances of each individual situation based on the criteria being promulgated in the CAS regulations.

c. References For Pursuing Cost Accounting Changes. The CAS rules, regulations, and administrative requirements for changes in cost accounting practices are contained in 48 CFR 9903.3, FAR 30.602, and CAS contract clause FAR 52.230-6, "Administration of Cost Accounting Standards." (See 8-303.3 and 8-500.)

d. Evaluating Cost Impact. When reviewing a joint venture or SBU to determine the cost impact on existing company(s) contracts, care must be taken to distinguish between (1) the cost impact due to the change in the measurement, allocation, and assignment of costs and (2) the impact due to the initial adoption of a cost accounting practice, or the partial or total elimination of a cost or the cost of a function, which are not considered changes in cost accounting practices under CASB rules and regulations.

7-1900 Section 19 --- Restructuring Costs

7-1901 Introduction

To achieve greater operating efficiencies and competitiveness, defense contractors are restructuring and consolidating as government procurements decline. On July 21, 1993, the Under Secretary of Defense (Acquisition) [USD(A)] issued a memorandum which states that it is in the government's best interest to encourage contractors to consolidate and restructure to reduce operating costs and thereby reduce contract costs. This section contains guidance for evaluating the contractor's restructuring proposal.

7-1902 Legislation and Regulations

a. For business combinations that occurred after August 15, 1994, Section 818 of the National Defense Authorization Act for Fiscal Year 1995 (P.L. 103-337) prohibits the reimbursement of restructuring costs associated with a business combination until an official at the Assistant Secretary of Defense level, or above, certifies in writing that projections of future cost savings are based on audited cost data and should result in overall reduced costs to the Department. This reimbursement requirement does not apply to any business combination for which restructuring costs were paid or otherwise approved by the Secretary prior to August 15, 1994.

b. For business combinations that occur after September 30, 1996, Section 8115 of the National Defense Appropriations Act for Fiscal Year 1997 (P.L. 104-201) requires that (1) audited savings for DoD exceed the costs allowed by a factor of at least two to one, or (2) savings must exceed costs and the Secretary of Defense must determine that the business combination will result in the preservation of a critical capability that might otherwise be lost to the Department.

c. Regulations implementing this legislation are at DFARS 231.205-70, Restructuring Costs. This section of DFARS prescribes policies and procedures regarding a contractor's external restructuring costs. Several steps are required before external restructuring costs may be reimbursed.

(1) The first step for the cognizant ACO is to promptly novate contracts when required. The novation agreement must include the provision at DFARS 242.1204(e) which allows increased costs on flexibly-priced novated contracts for restructuring, provided that the transferee demonstrates that the restructuring will reduce overall costs for DoD (and the National Aeronautics and Space Administration (NASA) when there is a mix of DoD and NASA contracts). DoD will not treat a shifting of costs from DoD contracts to NASA contracts as an overall cost reduction for DoD. Restructuring costs are not allowed until execution of the advance agreement required by DFARS 231.205-70(d)(8). Until the advance agreement is signed, restructuring costs should be suspended from any billings or final contract price settlements.

(2) The cognizant ACO must take other steps before restructuring costs may be either reimbursed on the flexibly-priced contracts that were awarded after the business combination or included in the price of future fixed-price contracts. The following steps are required by DFARS 231.205-70(d):

- The cognizant ACO will obtain an adequately supported proposal for planned restructuring projects from the contractor.
- The proposal must include a breakout, by year and by cost element, showing the projected restructuring costs and projected restructuring savings.
- The contractor's proposal will be audited to verify that projected costs are allowable under FAR Part 31 and DFARS Part 231 and that restructuring savings will exceed restructuring costs on a present value basis.
- The cognizant ACO will determine whether the restructuring should result in overall reduced costs for DoD, or, if applicable, audited savings will exceed costs allowed by a factor of at least two to one on a present value basis.
- The cognizant ACO will negotiate an advance agreement with the contractor setting forth, at a minimum, a cumulative cost ceiling for restructuring projects.

- The ACO will submit a recommendation for written determination of net benefit to the Under Secretary of Defense (Acquisition & Technology) [USD(A&T)].

(3) The advance agreement will not be executed until the USD(A&T) determines in writing that projections of future cost savings from the business combination are based on audited cost data and should result in overall reduced costs for the Department. Until the determination is obtained, the contractor must segregate restructuring costs and suspend them from billings, final contract price settlements, and overhead settlements as required by DFARS 231.205-70(d)(2).

(4) The audit, ACO review, and USD(A&T) determination requirements in DFARS 231.205-70 apply only to restructuring activities that (i) occur after a business combination, (ii) affect the operations of companies not previously under common ownership or control, (iii) are initiated within three years of the business combination, and (iv) result in costs allocated to DoD contracts of $2.5 million or more. The phrase "initiated within three years" means that a restructuring decision was made within three years of the business combination. Each of these four conditions must be met in order for DFARS 231.205-70 to apply.

(5) Testing for the $2.5 million materiality threshold should be based on the best information currently available. A decision that the threshold is not met should not be reversed in the future if conditions change (e.g., actual business mix differs from projected business mix) and actual DoD reimbursement exceeds $2.5 million. The materiality threshold applies to all restructuring activities associated with a business combination. It is not to be applied project by project or segment by segment. A general dollar magnitude estimate should be sufficient to determine if the $2.5 million threshold is met.

7-1903 Contents Of External Restructuring Proposals

a. The proposals for external restructuring costs required by DFARS 231.205-70(d)(3) must show projected restructuring costs and savings by year and by cost element. Data supporting the projections and the methods by which restructuring costs will be allocated must also be included.

b. The following basic elements should be part of any restructuring proposal and its supporting data:

- An outline of proposed restructuring actions, anticipated time span for accomplishing proposed actions, and the affected locations.
- A summary of proposed restructuring costs and savings, by year and by cost element, that includes the present value of the DoD share of projected costs and savings.
- Points of contact for obtaining clarification or additional information.
- A description of how restructuring costs will be accumulated and amortized (if restructuring costs will be accounted for as a deferred charge), and the methods by which restructuring costs will be allocated. External restructuring costs should be identified separately from internal restructuring costs, if any.
- A plan for updating forward pricing rates to reflect the impact of projected restructuring savings. Restructuring costs may also be reflected in the forward pricing rates provided the contracts priced with the rates include a downward price adjustment clause to remove restructuring costs should the certification required by DFARS 231.205-70(c)(1)(iv) not be obtained.
- Supporting data sufficient to establish the reasonableness of the cost and savings projections.

7-1904 Coordinated Audit Approach

a. A cycle time and integrated product team (IPT) approach to preparing and reviewing restructuring proposals is highly recommended. This involves early identification and resolution of issues that emerge during the contractor's preparation of the proposal and DCAA's audit of the proposal. The IPT should normally include contractor representatives who develop the proposal, auditors, and the cognizant ACO. DCAA auditors should work with the

contractor and ACO prior to the submission of the contractor's restructuring cost and savings proposal to reach agreement on the nature and extent of supporting data to be provided. Such coordination should reduce the possibility of inadequate or unnecessarily detailed proposal submissions while also reducing audit cycle time. Parts of the proposal may be reviewed as completed and issues should be addressed as soon as they are identified. The team should meet at an early stage (usually shortly after the business combination is announced) to share plans, discuss information needs, assess risk and level of proposal detail, and establish goals, milestones, and timeframes.

b. To accomplish effective and timely audits of contractor restructuring proposals at multi-segment contractors, it is important that the DCAA Contract Audit Coordinator maintain effective communications with the contractor and all affected DCAA offices throughout the review process.

7-1905 Purpose and Scope of Audit

a. The purpose of the audit of the contractor's external restructuring proposal is to verify that savings projected from the restructuring for DoD contracts will exceed the allowable restructuring costs projected for DoD contracts. For restructuring associated with business combinations that occur after September 30, 1996, projected savings for DoD must exceed costs allowed by a factor of at least two to one (see DFARS 231.205-70(c)(3)). Specifically, the audit should determine that:

- The contractor’s classification of costs as restructuring costs is proper.
- The projected restructuring costs are allowable, reasonable, and allocable to government contracts.
- The projected restructuring savings represent reasonable estimates of future cost reductions that will accrue to the government as a result of the contractor's restructuring activities.
- The restructuring savings will exceed restructuring costs on a present value basis.
- Savings resulting from the restructuring will exceed costs allowed by a factor of at least two to one for business combinations that occur after September 30, 1996.

b. While the nature and extent of audit effort required to accomplish these audit objectives will vary depending on individual circumstances, the scope of audit should be influenced by the following items:

- Risk that projected savings will not exceed projected costs by a wide margin.
- Types of government contracts.
- Existence of sensitive audit issues.
- Results of other audits (e.g., adequacy of estimating system and past reliability of estimates).
- Input from the contracting officer.
- Contract provisions.

c. These and other areas which may impact the scope of audit are discussed in detail in 3-104. The audit working papers should clearly document the impact of these considerations on the scope of audit.

7-1906 Evaluation of Projected Costs

7-1906.1 Definition of Restructuring Costs

a. Restructuring that is a direct outgrowth of a business combination is termed “external restructuring.” External restructuring costs are defined in DFARS 231.205-70(b)(4) as the costs, both direct and indirect, of restructuring activities. A restructuring activity is defined as:

- A nonroutine, nonrecurring, or extraordinary activity to combine facilities, operations, or workforce in order to eliminate redundant capabilities, improve future operations, and to reduce overall costs.
- It is not a routine or ongoing repositioning and redeployment of a contractor’s productive facilities or workforce.
- It is not a routine or ordinary activity charged as an indirect cost that would otherwise have been incurred (e.g., planning and analysis, contract administration and oversight, recur-

ring financial and administrative support.)

b. Planning for restructuring would not be a restructuring activity when performed by employees whose costs would otherwise have been incurred (e.g., G&A employees). However, planning for restructuring performed by outside consultants, attorneys, or other professionals whose charges would not otherwise have been incurred is a restructuring activity.

c. Direct contract costs might increase as a consequence of restructuring (e.g., recalibration of special test equipment that was moved to another plant, increased labor time per unit of production due to relocation of production). In these situations, direct costs may not be reclassified as indirect restructuring costs or allocated to other contracts. This is prohibited by Cost Accounting Standard 402 and applicable cost principles, including: FAR 31.202, Direct costs; FAR 31.203, Indirect costs; FAR 31.205-23, Losses on other contracts; and FAR 31.205-40, Special tooling and special test equipment costs.

7-1906.2 Evaluation Of Employee Related Costs

a. Employee Termination Costs. Employee termination costs such as early retirement incentive or severance payments may be incurred to effect reductions in the contractor's workforce as part of restructuring efforts. The auditor should review any proposed employee termination costs to determine if allowable under FAR 31.205-6, Compensation for personal services (see 7-1907).

b. Retention Pay. The cost of a plan introduced in connection with a change in ownership through which employees receive special compensation that is contingent upon the employee remaining with the contractor for a specified period of time is unallowable under FAR 31.205-6(l), Compensation incidental to business acquisitions. This cost principle is typically applicable to “golden handcuff” arrangements with key executives upon a business combination. It should not be applied to plans that provide additional dismissal wages to employees who remain with the contractor until their employment is involuntarily terminated (e.g., until a plant is closed). The allowability of such dismissal wages should be determined under FAR 31.205-6(g), Severance pay.

c. Employee Relocation Costs. Employee relocation costs may be incurred when a contractor's restructuring activities involve the consolidation of facilities or functions from different geographic locations. The auditor should review any proposed relocation costs to determine if allowable under FAR 31.205-35 and FAR 31.205-46 (see 7-1004).

d. Recruitment Costs. Recruitment costs may be incurred to hire employees at new or expanded contractor locations as a result of a contractor's restructuring activities. The auditor should review any proposed recruitment costs to determine if allowable under FAR 31.205-34 (see 6-408).

e. Employee Training. Employee training costs may be incurred to train employees on new or modified practices as a result of a contractor's restructuring activities. The auditor should review any proposed training costs to determine if allowable under FAR 31.205-44 (see 7-900).

f. Bonuses. See 6-414.7 for limitations applicable to DoD contracts.

g. Pension and Post Retirement Health Benefit Costs**.** After a business combination, a contractor may have employees who are covered by multiple pension and post retirement health benefit plans. As a result, the contractor may decide to modify the existing plans to provide for comparable benefits or to merge the plans together into a single plan covering all employees. The cost of implementing these changes and any associated increases in pension and post retirement health benefit costs do not meet the DFARS definition of restructuring costs. Depending upon their nature and extent, other changes and their associated cost increases may not meet the definition of restructuring costs (see DFARS 231.205-70). For example, increased pension costs resulting from changes in actuarial assumptions (e.g., changes in interest rates) would not meet the DFARS definition of restructuring costs. On the other hand, increases in actuarial liabilities

of the pension plan resulting from contractor implementation of an early retirement incentive plan would meet the DFARS definition of restructuring costs if done in connection with a restructuring activity. In either case, the auditor may need to establish a separate review to determine if the changes are in compliance with the requirements of FAR 31.205-6, CAS 412, and 413 (see 7-600, 8-412 and 8-413).

7-1906.3 Evaluation of Facilities Related Costs

a. Idle Facilities. FAR 31.205-17, Idle facilities and idle capacity costs, provides that costs of idle facilities are allowable for a reasonable period of time, usually not to exceed one year, depending upon the initiative taken to use, lease, or dispose of the idle facilities. The regulation provides the contracting officer with the flexibility to accept idle facilities costs for a period greater than one year. When the contractor has identified facilities that are expected to be idle in excess of one year, the auditor should recommend that the contracting officer obtain justification from the contractor for the time in excess of one year. The contractor should address, at a minimum, the following areas:

- Whether the facility will be needed in the future, and if so, why.
- If not needed for future operations, the actions that are being taken to lease or dispose of the facility.
- An estimate of the time it should take to lease or dispose of the facility based on an analysis of existing market conditions; such as surveys of real estate prices, public records of real estate sales for similar facilities, etc.

The auditor should assist the contracting officer in determining a reasonable period of time for accepting idle facilities costs. The contractor and government should enter into an advance agreement specifying the maximum period for which costs of idle facilities will be reimbursed. If there is no advance agreement between the contractor and the contracting officer to accept idle facilities costs for a period greater than one year, any proposed idle facilities costs beyond one year should be questioned.

b. Extraordinary Maintenance and Repairs. The costs of extraordinary maintenance and repairs are allowable under FAR 31.205-24(a)(2) although such costs incurred to prepare a facility for sale are generally factored into the calculation of the gain or loss on the sale. The costs of restoring or rehabilitating the contractor's facilities to approximately the same condition existing immediately before the start of a government contract, fair wear and tear excepted, are limited in allowability by FAR 31.205-31, Plant reconversion costs. Ideally, such costs would be covered by an advance agreement on idle facilities or restructuring.

c. Asset Relocation. Asset relocation costs include the cost of removing the asset from its current location, transportation to the new location, and reinstalling the asset at the new location. Merely moving an asset from one location to another generally does not extend its expected service life or production capacity. Therefore, relocation costs are generally assigned to the cost accounting period in which they are incurred. When incurred in connection with restructuring, Cost Accounting Standard 406.61 provides that asset relocation costs may be included as restructuring costs. When reviewing asset relocation costs, auditors should be alert for the possibility that assets might be improved or bettered in connection with their relocation. If the useful life of a tangible capital asset will be extended or its productivity increased, then the cost of the improvement or betterment should be capitalized and depreciated over the remaining useful life of the asset in accordance with CAS 404.40(d) [see 8-404]. The capitalized costs of betterments or improvements are eligible for facilities capital cost of money under CAS 414. The reasonableness of proposed relocation costs should be determined under FAR 31.201-3, Determining reasonableness.

d. Gain/Loss on Sale of Assets. Restructuring is an extraordinary activity that may involve mass or extraordinary dispositions of assets. Dispositions may range from equipment, such as surplus furniture or computer hardware, to an entire plant. The actual gains or losses

realized upon disposition of depreciable assets should be reviewed to determine if they are allowable under FAR 31.205-16 (see 7-412). Proposed gains or losses, which have not been realized and are not based on a firm sales agreement should be treated in accordance with FAR 31.205-7, Contingencies. The gain or loss expected from the sale of items for which there is a ready market may be foreseeable within reasonable limits of accuracy. Such projected gains or losses should be included in cost estimates as stated in FAR 31.205-7(c)(1). When a gain or loss cannot be measured or timed within reasonable limits of accuracy, the contractor should exclude it from cost estimates and propose it as a contingency in accordance with FAR 31.205-7(c)(2). When reviewing the contractor's proposed gains or losses, the auditor should be alert for any asset write-ups or write-downs that may have occurred as a result of the business combination (see 7-1705).

e. Environmental Remediation**.** Environmental cleanup efforts may arise in connection with a contractor's restructuring activities. In general, environmental remediation costs (e.g., cleanup of soil or ground water contamination, removal of asbestos from buildings) do not meet the DFARS definition of restructuring costs. Therefore, these costs should be excluded from the contractor's restructuring cost and savings proposal and negotiated under a separate advance agreement. The cleaning of a building in preparation for its sale (e.g., cleaning air ducts, removing chemical stains from floors) should normally be treated as extraordinary maintenance and repairs, not environmental remediation (see 7-2120).

7-1906.4 Evaluation of Other Categories of Costs

a. Discontinued Operations. During the restructuring process, a contractor may have continuing costs associated with discontinued operations (i.e., a segment that is merged, sold, or abandoned). Generally, costs associated with segments that are merged into one or more new or existing segments should be allocated to the new or existing segment where the work effort or contracts are transferred. However, some costs may be addressed by a specific procurement regulation. Pension costs, for example, associated with closed segments should be measured, assigned and allocated in accordance with CAS 413.50(c)(12)). For other costs, special allocations may be required under CAS 403 or CAS 418. To ensure the appropriate regulation is properly applied, the FAO should coordinate with Headquarters (Accounting and Cost Principles Division), through the regional office, when significant costs associated with discontinued operations are encountered.

b. Organization and Reorganization Costs. The auditor should be alert for organization or reorganization costs, unallowable under FAR 31.205-27, that may have been included in the contractor's restructuring cost and savings proposal. In addition, when a contractor's restructuring activities result in the formation or dissolution of separate entities, the auditor should ensure that any organization or reorganization costs are properly excluded from the contractor's restructuring cost and savings proposals and forward pricing rates. Depending upon the nature and extent of contractor organization or reorganization activities, the auditor may need to establish a separate review to ensure that all associated costs have been properly segregated and excluded from government contracts (see 7-1707)

c. Facilities Capital Cost of Money. Deferred restructuring costs should not be included in the computation to determine facilities capital cost of money (see CAS 406.61(i)). Deferred charges are not tangible or intangible capital assets as defined in CAS 414.30.

d. Credits. Reductions in workforce and facilities should reduce the cost of various employee benefit plans (e.g., health insurance, life insurance) and property and casualty insurance plans. This may lead to credits from insurance companies as reserves are reduced or policies canceled. Auditors should be alert for such credits and the requirement in FAR 31.201-5 for the applicable portion to be credited to the government either as a cost reduction or by cash refund, as appropriate (see 6-203).

7-1907 Evaluation Of Projected Savings

a. Contractor restructuring efforts are intended to result in combinations of facilities, operations, or workforce that eliminate redundant capabilities, improve future operations, and reduce overall costs. Benefits which accrue to the government from a contractor's restructuring efforts are the overall reduced costs on future contracts and existing flexibly-priced contracts. Cost reductions on already negotiated firm-fixed-priced contracts are not savings to the government.

b. Auditors should carefully evaluate proposed restructuring savings to ensure that the contractor's estimates of future cost reductions are reasonable and can be expected to benefit government contracts. To accomplish this, the auditor must first establish that the contractor's baseline for measuring restructuring savings represents a reasonable expectation of future contract costs had the restructuring not occurred. Contractor budgets, contract estimates to complete, and existing forward pricing rate proposals/agreements can be used to establish a baseline for pre-restructuring costs. It is the contractor's responsibility to establish and support the reasonableness of the baseline used in developing savings estimates.

c. Once a reasonable baseline has been established, the auditor should review the proposed restructuring savings to ensure that estimated cost reductions are the result of the contractor's restructuring efforts and not due to other factors (e.g., reduced inflation rates, changes in interest rate assumptions) impacting on future contract costs. Materiality should be considered in planning the review. The use of statistical sampling should also be considered (see 3-104.17 and 4-605a.).

7-1908 Determination Of Present Value And Overall Reduced Costs

a. DFARS 231.205-70(d)(7) requires the cognizant ACO to determine if restructuring savings will exceed restructuring costs on a present value basis. The auditor should review the contractor's methodology for discounting projected restructuring costs and savings to determine if it is reasonable under the circumstances. Overall reduced costs should be computed based on restructuring costs and savings which will be realized over the next five years. Those costs and savings which are not stated in current year dollars should be discounted to current year dollars using the most recently published cost of money rate.

b. DFARS 231.205-70(d)(8) requires the cognizant ACO to negotiate an advance agreement with the contractor that includes a cumulative cost ceiling. The cost may not exceed the amount of projected restructuring savings on a present value basis. Auditors should provide any assistance requested by the ACO in making present value calculations during negotiation of the advance agreement. For business combinations that occur after September 30, 1996, there is an additional requirement at DFARS 231.205-70(c)(1)(iv) that projected savings exceed costs allowed by a factor of at least two to one.

7-1909 CAS Considerations

7-1909.1 Assignment of Costs to Accounting Periods

a. The Cost Accounting Standards (CAS) Board issued the interpretation at CAS 406.61 on June 6, 1997. It is based on Interim Interpretation 95-01, “Allocation of Contractor Restructuring Costs Under Defense Contracts,” which was issued by the CAS Board on March 8, 1995. The interpretation clarifies whether restructuring costs are to be treated as an expense of the current period or as a deferred charge that is subsequently amortized over future periods. It is applicable to contractor restructuring costs (both external and internal) that are paid or approved on or after August 15, 1994.

b. Paragraph (e) of CAS 406.61 (and preceding Interim Interpretation 95-01) require that the costs of all restructuring activities comprising a specific restructuring event be accounted for as a deferred charge unless the contractor proposes, and the contracting officer agrees, to expense the costs in the current

accounting period. A contractor may defer the costs of one restructuring event (e.g., restructuring in connection with acquisition of Company A) and propose to expense the costs of a subsequent restructuring event (e.g., restructuring in connection with Company B years later), subject to the CAS Board rules governing accounting practice changes. However, a contractor may not defer the costs of some activities and expense the cost of others that comprise a specific restructuring event. According to CAS 406.61(e), "Contractor restructuring costs defined pursuant to this section may be accumulated as deferred cost, and subsequently amortized, over a period during which the benefits of restructuring are expected to accrue. However, a contractor proposal to expense restructuring costs for a specific event in a current period is also acceptable when the Contracting Officer agrees that such treatment will result in a more equitable assignment of costs in the circumstances."

c. The Director, Defense Procurement, issued guidance on May 20, 1997 which stated that it would be appropriate to accept a contractor's proposal to expense restructuring costs in the current period when expensing should result in overall lower costs for DoD. In making this assessment, the business base (government versus commercial contracts) and the contract mix (fixed price versus cost reimbursement) for current and future years should be considered.

d. Deferred restructuring costs should be amortized over the same period of time during which the benefits of restructuring are expected to accrue. However, the amortization period is limited by CAS 406.61(h) which states: "The amortization period for deferred restructuring costs shall not exceed five years. The straight line method of amortization should normally be used, unless another method results in a more appropriate matching of cost to expected benefits."

7-1909.2 Allocation to Cost Objectives

a. Direct Restructuring Costs. Restructuring costs which benefit a single cost objective should be charged directly to that cost objective. For example, if a contractor's restructuring activities result in a need to recalibrate special test equipment which is related to a single contract, the recalibration costs should be assigned directly to that contract.

b. Indirect Restructuring Costs. CAS 406.61(j) states: "Restructuring costs incurred at a home office level shall be treated in accordance with the provisions of 9904.403. Restructuring costs incurred at the segment level that benefit more than one segment should be allocated to the home office and treated as home office expense pursuant to 9904.403. Restructuring costs incurred at the segment level that benefit only that segment shall be treated in accordance with the provisions of 9904.418. If one or more indirect cost pools do not comply with the homogeneity requirements of 9904.418 due to the inclusion of the costs of restructuring activities, then the restructuring costs shall be accumulated in indirect cost pools that are distinct from the contractor's ongoing indirect cost pools."

7-1909.3 Disclosure of Accounting Practices and Changes in Accounting Practices

a. Accurate disclosure statements are required by 48 CFR 9903.202-3. If the deferral of restructuring costs results in a new or changed cost accounting practice, the contractor is required to file a revised disclosure statement describing the accounting practices associated with the assignment and allocation of deferred restructuring costs. The contractor is also required to revise its disclosure statement for any other changes in cost accounting practice that result from the restructuring. Audits of the revised disclosure statement should be conducted in accordance with Chapter 8.

b. CAS 406.61(f) states: "If a contractor incurs restructuring costs but does not have an established or disclosed cost accounting practice covering such costs, the deferral of such restructuring costs may be treated as the initial adoption of a cost accounting practice (see 9903.302-2(a)). If a contractor incurs restructuring costs but does have an existing established or

disclosed cost accounting practice that does not provide for deferring such costs, any resulting change in cost accounting practice to defer such costs may be presumed to be desirable and not detrimental to the interests of the government (see 9903.201-6). Changes in cost accounting practices for restructuring costs shall be subject to disclosure statement revision requirements (see 9903.202-3), if applicable."

c. Contractor restructuring activities may also result in changes to cost accounting practices other than deferral of restructuring costs. For example, as a direct result of restructuring activities, the contractor may decide to change from a value-added base to a total cost input base for allocation of its G&A pool. Effective June 14, 2000, the cost impact process does not apply to cost accounting practice changes directly associated with external restructuring activities that are subject to, and meet the requirements of, 10 U.S.C. 2325. This statute established the allowability requirements and two-to-one savings requirements for external restructuring implemented by DFARS 231.205-70. Cost accounting practice changes associated with restructuring activities that (1) took place prior to June 14, 2000 or (2) do not meet the requirements of 10 U.S.C. 2325 are subject to the administrative procedures outlined in the CAS contract clause at 48 CFR 9903.201-4(a)(4). See further guidance in 8-503.4.

7-1910 Reporting Results Of Audit

Audit reports should follow the format contained in 10-300, Audit Reports on Price Proposals, modified as appropriate. To promote consistency, external restructuring cost and savings proposal audit reports should be reviewed prior to issuance by the Regional Office, and when applicable, the Contract Audit Coordinator (CAC). The audit report on the first restructuring proposal following a business combination should also be reviewed by Headquarters prior to issuance. Auditors should take appropriate actions to ensure that sufficient time is available to facilitate these reviews within the required due dates.

7-1911 Forward Pricing Consideration

7-1911.1 Adjustment of Forward Pricing Rates

a. A plan for updating forward pricing rates to reflect the impact of projected restructuring costs and savings should be developed with the contractor and cognizant ACO at an early stage. Upon receipt of the contractor's restructuring cost and savings proposal, the auditor should be prepared to advise the cognizant ACO on the contractor's adjustments to forward pricing rates to reflect the impact of projected restructuring costs and savings.

b. DFARS 231.205-70(d)(5) requires that the cognizant Administrative Contracting Officer adjust forward pricing rates to reflect the impact of projected restructuring savings as soon as practicable.

7-1911.2 Reopener or Savings Clauses in Forward Pricing Reports

a. DFARS 231.205-70(d)(5) provides that "if restructuring costs are included in forward pricing rates prior to execution of an advance agreement in accordance with DFARS 231.205-70(d)(8), the contracting officer shall include a repricing clause in each fixed price action that is priced based on the rates. The repricing clause must provide for a downward price adjustment to remove restructuring costs if the DoD certification required by 231.205-70(c)(1)(iv) is not obtained.

b. In addition to the repricing clause required by DFARS 231.205-70(d)(5), the auditor should recommend contract reopener or savings clause in the audit report on a contract price proposal when a major contractor acquisition, merger, or associated restructuring is significant and the effect on the price proposal cannot be reasonably determined (see 10-304.4c(8)).

7-1911.3 TINA Considerations

A management decision to restructure is cost or pricing data that must be disclosed for compliance with the Truth in Negotiations Act (TINA). An adequate disclosure requires current, accurate, and

complete information on the nature and magnitude of the restructuring decision. Typically, judgments on the effects of a restructuring decision (i.e., estimated cost reductions) are so intertwined with facts that they cannot be segregated. In this case, complete data must be disclosed to place the government on an essentially equal footing with the contractor when making pricing decisions. Thus compliance with TINA will usually require disclosure of the impact of restructuring decisions on forward pricing rates and contract price proposals. As indicated in 9-1211, whenever the auditor has an indication that forecasted rates should have been revised for significant changes to reflect more accurate, complete, or current cost or pricing data, pricing actions using the rates should be subject to a postaward audit when cost or pricing data was required.

7-1912 Reimbursement Of External Restructuring Cost

a. DFARS 231.205-70(d)(2) requires the cognizant ACO to direct the contractor to segregate restructuring costs and to suspend these amounts from any billings, final contract price settlements, and overhead settlements until written determination is obtained from USD(A&T). When contractors incur restructuring costs prior to obtaining certification, the auditor may need to evaluate the contractor's internal controls to determine if they are adequate to reasonably ensure that restructuring costs are properly accounted for and excluded from contract billings, final contract price settlements, and overhead settlements. This evaluation should include limited transaction testing to determine if the controls have been implemented and are working effectively. Floor checks (see 6-405) or other time sensitive audit procedures may be performed when appropriate for the risks identified.

b. Costs of activities such as restructuring planning and analysis, contract administration and oversight, and recurring financial and administrative support, when performed by employees whose costs would otherwise have been incurred, are not restructuring costs as defined by DFARS 231.205-70(b)(2). Therefore such costs should not be excluded from contract billings, final contract price settlements, and overhead settlements merely because the certification required by DFARS 231.205-70(c)(1)(iv) has not been obtained.

7-1913 Audit Consideration - Internal Restructuring Cost

a. The term “internal restructuring activities” means all restructuring activities that are not subject to DFARS 231.205-70. While DFARS 231.205-70 does not apply to internal restructuring activities, an advance agreement on internal restructuring costs should be recommended since the costs are unusual and can be substantial. This is particularly true if the cost is to be accounted for as a deferred charge. FAR 31.109(a) advises contracting officers and contractors to seek advance agreement on the treatment of special or unusual costs to avoid possible subsequent disallowance or dispute based on reasonableness, nonallocability, or unallowability.

b. Auditors may encounter internal restructuring costs in audits of proposals for advance agreements on restructuring, forward pricing rate proposals, contract price proposals, or incurred cost claims. As with any other cost, the policies and procedures within the Federal Acquisition Regulation (FAR) and DoD supplement (DFARS) should be followed in determining the allowability of internal restructuring costs.

c. The criteria in FAR 31.201-3 should be applied in determining the reasonableness of internal restructuring costs. Evidence of reasonableness might include an analysis of costs and benefits (e.g., reduced costs, more efficient use of resources, improved financial capability). The criteria in FAR 31.201-4 should be applied in determining the allocability of internal restructuring costs. Allocations of restructuring costs should comply with applicable Cost Accounting Standards. The interpretation at CAS 406.61 is applicable to internal restructuring costs. Costs properly classifiable as internal

restructuring costs may be deferred and subsequently amortized over a period during which the benefits of restructuring are expected to accrue (not to exceed 5 years).

d. Auditors should be alert for contracts with provisions for costs associated with restructuring. For example, a contract may contain an allowance for the costs of relocating special equipment and tooling to a vendor from a contractor's discontinued operation or closed facility. Such costs would be charged directly to the contract and, as direct contract costs, would not be allocable to other cost objectives as restructuring costs. Auditors should also be alert for existing advance agreements covering costs that may arise in connection with restructuring. Significant environmental remediation costs may coincide with restructuring but are not restructuring costs and should be covered by a separate advance agreement.

e. The contractor should include the reduction in overall cost levels expected from internal restructuring into its forward pricing rates and contract price proposals. If this does not occur, auditors should follow procedures in 9-1208c and 9-1209b in advising the cognizant ACO to request a revised forward pricing rate proposal from the contractor.

7-1914 Auditing Incurred Restructuring Costs

a. The final determination of allowability of incurred restructuring costs can only be made after the contractor provides the annual certified incurred cost proposal. FAR 52.216-7, Allowable Cost and Payment, and FAR 42.705-1, Contracting Officer Determination Procedure, require the contractor to support its proposal with adequate data. The auditor should obtain from the contractor whatever data is deemed necessary to support the amortized restructuring costs claimed (e.g., amortization schedules for deferred restructuring costs and detailed schedules of the incurred restructuring costs by fiscal year, project and cost element). The support should be at a level of detail sufficient to allow the auditor to determine the allowability of incurred restructuring costs.

b. As actual restructuring expenditures near the negotiated restructuring cost ceiling, there is an increased risk that restructuring costs may be misclassified as other costs. Procedures should be performed to identify costs that should properly be reclassified as restructuring costs, especially when incurred restructuring costs are near or in excess of the negotiated ceiling.

7-2000 Section 20 --- Reserved

7-2100 Section 21 --- Other Areas of Cost

7-2101 Introduction

This section covers other areas of cost not requiring a full section coverage at this time.

7-2102 Purchased Labor -- Personnel Procured From Outside Sources

Some contractors have adopted the practice of obtaining engineers, technical writers, technicians, craftsmen, and other personnel by subcontract (commonly called "Purchased Labor") rather than by direct hire. Such practice, if for any reason other than to meet temporary or emergency requirements, should be carefully studied to determine whether any additional costs resulting therefrom are reasonable, necessary, and properly allocable to government contracts.

7-2102.1 Audit Considerations

a. Contractors' accounting treatment of purchased labor varies depending on the circumstances under which purchased labor costs are incurred. For example, some contractors classify purchased labor as direct labor costs when the work is performed in the contractor's facilities and under their supervision and otherwise meets the FAR definition of direct costs. These contractors cost such effort using the average labor rate incurred by their own employees for comparable work. Differences between the amounts derived and purchased labor prices are treated as overhead costs and are allocated accordingly. Other contractors classify purchased labor as subcontract costs. The accounting treatment used should be evaluated on a case-by-case basis as discussed in 7-2102.2.

b. Purchased labor most likely causes no fringe benefits and other employee-related costs to be incurred by the contractor. Such costs are generally paid by the entity providing personnel performing the effort.

c. A fundamental requirement of CAS 418 is that pooled costs shall be allocated to cost objectives in a reasonable proportion to the causal or beneficial relationship of the pooled costs to cost objectives. Purchased labor must share in an allocation of indirect expenses where there is a causal or beneficial relationship, and the allocation method must be consistent with the contractor's disclosed accounting practices. In accordance with CAS 418, a separate allocation base for purchased labor may be necessary to allocate significant overhead costs to purchased labor such as supervision and occupancy costs, or to eliminate other costs not benefiting purchased labor such as fringe benefits costs.

d. Where the effort of purchased labor is performed in-house using the contractor's supervision and facilities, overhead exclusive of fringe benefits and other employee related costs, if material in amount, should be allocated to purchased labor. Conversely, where the effort of purchased labor is performed offsite under the supervision and control of an entity other than the contractor, none of the contractor's labor overhead costs may be allocable to purchased labor.

7-2102.2 Audit Procedures

The accounting treatment for purchased labor must be evaluated on a case-by-case basis with consideration given to the materiality of costs involved and the overall effect of the accounting treatment on final cost objectives. Acceptance or rejection of the contractor's treatment of purchased labor must be based upon (1) the causal and beneficial relationship of indirect expenses and purchased labor, and (2) the nature of the employer/consultant relationship using the Internal Revenue Services arms-length tests. In making this assessment, the auditor should:

a. Review the contractor's policy, with emphasis on the criteria used in determining whether personnel should be obtained from outside sources instead of by direct hire.

b. Analyze the purchased labor during the current or most recently completed

fiscal year, whichever provides sufficient information, to:

(1) Determine the number of purchased labor personnel and the duration of their engagement.

(2) Compare the number of employees on the contractor's payroll (in each classification of purchased labor involved) with the number of equivalent personnel obtained from outside sources.

(3) Compare the cost per staff-year with the contractor's comparable personnel.

(4) Evaluate the contractor's reasons for resorting to the practice. This is particularly important where the engagement extends beyond one year.

(5) Determine whether the contractor's practices are equitable with respect to the utilization of purchased labor on government contracts as compared to commercial work, and on fixed-price contracts as compared to cost-type contracts; and whether the accounting treatments of the costs of such personnel and contractor personnel performing the same kind of work, including allocation of related overhead expenses, are equitable.

c. Coordinate with government production specialists, project engineers, purchase methods analysts, and others on matters such as the effectiveness of performance, staffing requirements, equivalent job classifications, and the award and pricing of the agreements.

d. Examine prior years' records to determine if the practice shows an increasing or decreasing trend.

7-2103 Employee Welfare and Morale Expense

Employee welfare and morale expenses are costs incurred on activities to improve working conditions, employer-employee relations, employee morale, and employee performance. Expenses and income generated by employee welfare and morale activities should be reviewed for compliance with FAR 31.205-13. Note that employee morale type expenses are often covered by the entertainment cost principle, 31.205-14. FAC 90-31, effective October 1, 1995, clarified that entertainment costs are not allowable under any other cost principle. By statute, entertainment costs are expressly unallowable, without exception. Consequently, the entertainment cost principle at FAR 31.205-14 takes precedence over any other cost principle.

7-2103.1 Audit Considerations

a. General

(1) Aggregate costs incurred for employee welfare and morale, less credits for income generated by these activities, are allowable except as noted in paragraphs b. through e. below, to the extent that the net amount is reasonable. In applying the provisions of FAR 31.201-3, Reasonableness, the auditor should consider whether the expenditure is reasonable in nature and amount both for the contractor as a whole and for the employee(s) benefited by the expenditure.

(2) Costs relating to welfare and morale activities, if significant, should be subjected to the test of reasonableness as to purpose and amount (also see 7-1203.2a.). When reasonableness as to purpose has been established, reasonableness of amount should ordinarily be applied to overall amounts and not to individual items of cost, provided the items are not made specifically unallowable by FAR Part 31.

b. Employee Associations

(1) If a contractor has an arrangement permitting an employee association to retain the income from vending machines, such income should be considered in evaluating the total cost of the employee welfare and morale program as if the contractor received the income (FAR 31.205-13(c) and (d)). The auditor should examine the records of the employee association to ascertain that the income was reasonably expended for the purposes intended and that there is no undue accumulation of unspent funds. Any such accumulation should accrue to the government by treating it as a deduction from otherwise allowable overhead.

(2) In some instances, employee associations may use the vending machine income for the purchase of recreational and other employee welfare tangible personal or real property, or the employee association may purchase assets by means of a loan or mortgage. Allowable costs on capital assets thus purchased are limited to the

equivalent amount of costs that would be allowable if the contractor had acquired the property and incurred the costs directly (FAR 31.205-13(d)). Accordingly, allowable costs will normally be restricted to ownership costs such as depreciation, insurance, taxes, etc. The total expenditure for property should not be allowed as a cost in the year of purchase, except where the property involved is of the type that would be expensed under the contractor's normal accounting practices.

c. Major Property Acquisitions for Employee Welfare Purposes

The reasonableness of major property acquisitions for employee welfare purposes is necessarily a matter of some significance. The auditor should review such purchases to determine whether (1) they are reasonable under the criteria set forth in FAR 31.201-3 and (2) costs resulting therefrom are properly allocable to government contracts. If the assets acquired are not of a type generally recognized as ordinary and necessary for purposes of employee welfare and morale, the related costs may be considered unreasonable and, therefore, not acceptable. A situation fitting this category would be when the acquisition benefits only a limited number, or certain classes, of employees. As a further consideration, real property donated or acquired from contributions made by the contractor should be carefully scrutinized, as it would seldom be reasonable for the contractor to give the property to its employee organization. Doing so would not as a rule give the employee association any benefit from the use of the property that it would not enjoy had the contractor retained title. By retaining title the contractor would keep a valuable asset which could be converted to other use or sold when it is no longer needed for its original purpose.

d. Cafeteria Losses

(1) The costs of cafeteria operations should include all indirect expenses pertaining to these services, as required by the full absorption cost methods prescribed by CAS 418. Auditors will verify that an allocable share of occupancy costs are included in the calculation of the total costs of cafeteria operations.

(2) Losses from operating cafeterias may be included as costs only if the contractor's objective is to operate such services on a break-even basis. One factor to consider is whether the prices charged are comparable to those available in commercial establishments. Losses sustained because these services are furnished without charge or at unreasonably low prices obviously would not be conducive to the accomplishment of the above objective and are not allowable. However, a loss may be allowable, provided the contractor can demonstrate that unusual circumstances exist such that even with efficient management, operating the service on a break-even basis would require charging inordinately high prices, or prices higher than those charged by commercial establishments. Examples of unusual circumstances are: (1) adequate commercial facilities are not available, or (2) reasonable prices are a necessary incentive to keep employees onsite to avoid the more significant costs of lost productive time due to longer lunch periods if the services were not provided.

(3) When cafeteria losses are claimed by the contractor, it is the contractor's responsibility to demonstrate that unusual circumstances exist and to provide supporting documentation such as price comparisons with similar commercial establishments, or the distance of restaurants. The auditor should determine the validity of the contractor's justifications on a case-by-case basis. If the contractor fails to provide adequate documentation justifying the allowability of such losses, the auditor should question the costs.

e. Gifts, Recreation, and Entertainment

For contracts issued on or after January 13, 1995, costs of gifts, recreation, and entertainment incurred subsequent to September 30, 1995 were made specifically unallowable, with a few exceptions (see FAC 90-31).

(1) Although gifts are an expressly unallowable expense, the cost principle specifically excludes two categories of awards from the unallowable gift definition: (a) Awards covered by the compensation cost principle at 31.205-6; and (b) Awards made pursuant to an established plan or policy for recognition of employee achievements.

(2) Recreation expenses are an expressly unallowable expense with the

following exception: Costs of employees' participation in company sponsored sports teams or employee organizations designed to improve company loyalty, team work, or physical fitness. The exception does not allow general recreation activities and does not allow any costs disallowed by FAR 31.205-14, Entertainment. If the government challenges the allowability of claimed recreation costs, it is the contractor's responsibility to establish that the cost claimed meets the following criteria:

(a) The cost is for employee participation in a sports team or employee organization.

(b) The team or organization is company sponsored.

(c) The team's or organization's activity is designed to improve company loyalty, team work, or physical fitness.

(3) Entertainment costs are expressly unallowable, without exception. Therefore, even if the principal purpose for incurring an entertainment cost is other than for entertainment, the entertainment cost is unallowable. For example, while the cost of a contractor open house for employee families is generally allowable, the cost of entertainment provided as part of the open house is unallowable.

(4) Taken together, the statute and the cost principles at 31.205-13, Employee morale, and 31.205-14, Entertainment, expressly disallow costs which some contractors may have considered reasonable and allowable prior to the effective date of the current rule, October 1, 1995. Examples of such costs include, but are not limited to:

(a) Entertainment provided as part of public relations, employee relations, or corporate celebrations;

(b) Gifts to anyone who is not an employee;

(c) Gifts to employees which are not for performance or achievement or are not made according to an established plan or policy;

(d) Compensation awards of entertainment, including tickets to shows or sports events, or travel; and

(e) Recreational trips, shows, picnics, or parties.

7-2104 Help-Wanted Advertising Costs

Help-wanted advertising costs are generally allowable per FAR 31.205-1 if the advertisement complies with the requirements of FAR 31.205-34. Also see 6-407.

7-2104.1 Audit Considerations

a. Paragraph (b) of FAR 31.205-34 (Recruitment costs) lists conditions that cause the costs of the help-wanted advertisement to be unallowable. These conditions and related audit considerations follow:

(1) Prior to May 3, 1999, FAR 31.205-34(b)(1) stated that help-wanted advertising costs for personnel other than those required to perform obligations under a government contract are unallowable. This provision should not be interpreted as disallowing help-wanted advertising costs applicable to indirect employees, such as accountants, internal auditors, lawyers, etc. This provision did, however, prohibit help-wanted advertising costs that are for personnel peculiar to the performance of obligations under commercial contracts. Effective May 3, 1999, this provision was removed from FAR 31.205-34 because it duplicates the allocability provisions already discussed in FAR 31.201-4.

(2) Help-wanted advertising which does not describe specific positions or classes of positions is unallowable. For example, advertising aimed at building a backlog of resumes, rather than filling specific job openings would fall under the unallowable category. Review of the contractor's help-wanted advertisement and replies to applicants should help to determine whether or not the advertisement is one for filling specific job openings. When the contractor is observed to be expanding its current work force, an audit lead should be developed and pursued in a subsequent audit to determine whether the contractor's projected base used for estimating overhead rates considers such expansion.

(3) Advertising which is excessive in relation to the number and importance of the positions, or in relation to the practices of the industry, is unreasonable and therefore unallowable. Inherent in any such determination is not only the size of a par-

ticular advertisement in a publication, but also the length and frequency of recruitment advertising in all media (including radio and television). Consideration must also be given to the effectiveness of the advertising program in terms of responses by qualified personnel and the number of hires. This is an area in which technical assistance from the administrative contracting officer can be most useful.

(4) Help-wanted advertising which includes material that is not relevant for recruitment purposes, such as extensive illustrations or descriptions of the company's products or capabilities, is unallowable. Conversely, allowable recruitment advertising should be limited to information such as:

(a) Description of the position(s) being offered.

(b) Description of the compensation and fringe benefits.

(c) Qualifications of the applicant(s).

(d) Opportunities for advancement.

(e) Brief description of the company and its work.

(f) Pertinent illustrations, conservative in size, that do not evidence promotion of the sale of the contractor's products or fostering of its image.

(g) Name of the company, conservatively presented in relation to the other information in the advertisement.

(h) Prior to May 3, 1999, help-wanted advertising (in publications) which includes color (other than black and white) is unallowable. Effective May 3, 1999, the prohibition of color in help-wanted advertisements has been removed.

(i) Prior to May 3, 1999, recruitment advertising designed to "pirate" personnel from another government contractor is unallowable. Falling into this category is advertising that specifically offers excessive fringe benefits or salaries significantly in excess of those generally paid in the industry for the skills involved. Usually, advertising of this nature would also contain features which would render it unallowable within one or more of the other limitations noted above. Effective May 3, 1999, the costs are no longer unallowable merely because the contractor’s intent was to “pirate” the employee from another government contractor.

b. By reason of the several restrictions placed on their allowability, help-wanted advertising costs become a sensitive audit area. Accordingly, the auditor should review any corollary help-wanted advertising costs as well as the costs of the advertising media themselves. The costs of photographs, art and design work, radio and television tapes, whether purchased or incurred in-house, are examples of corollary advertising costs.

7-2105 Professional and Consultant Service Costs

Professional and consultant service fees represent costs of services rendered by persons who are members of a particular profession or possess a special skill and who are not officers or employees of the contractor. Such costs include those of outside accountants, lawyers, actuaries, and marketing consultants. Contractors should be requested to obtain billings from outside professionals and consultants that itemize amounts applicable to retainer agreements, fees for services not covered by a retainer, expenditures for investigative and other services, travel, and miscellaneous expenses.

7-2105.1 General Considerations on Outside Professional and Consultant Services

a. The cost principle covering outside professional and consultant services is contained primarily in FAR 31.205-33, Professional and consultant service costs. However, consider other cost principles (e.g., FAR 31.205-27 Organization costs; 31.205-30 Patent costs; and 31.205-47 Costs associated with a legal or administrative proceeding) in determining allowability since efforts covered by these cost principles are often performed by consultants.

b. Properly supported professional and consultant service costs (see 7-2105.2) are generally allowable per FAR 31.205-33 when reasonable in relation to the services rendered, unless they are for activity made unallowable by other cost principles (see 7-2105.3).

c. The auditor should carefully consider the factors listed in FAR 31.205-33(d) in

determining the allowability of professional and consultant service costs. Some of the factors to be considered include:

(1) the nature and scope of the services rendered in relation to the service required,

(2) the impact of government contracts on the contractor's business, and

(3) whether the service can be performed more economically by employment rather than by contracting.

d. Contractors may engage outside professionals and consultants on a retainer-fee basis. FAR 31.205-33(e) requires that allowable retainer fees be supported by evidence that:

(1) the services covered are necessary and customary,

(2) the fee is reasonable in comparison with maintaining an in-house capability, and

(3) the level of past services justifies the amount of the retainer fees.

The supporting evidential matter requirements discussed in 7-2105.2 also apply to retainer agreements, except retainer agreements are not required to (and generally do not) have specific statements of work.

e. The auditor should assess the risk that there are irregularities associated with consultant costs, for example, attempts to conceal unallowable political donations or bribes by classifying them as consultant fees.

7-2105.2 Adequacy of Supporting Evidential Matter

a. FAR 31.205-33(f) contains three specific documentation requirements that must be met for professional and consultant service costs to be allowable. These requirements are:

(1) Details of all agreements (e.g., work requirements, rate of compensation, and nature and amount of other expenses if any) and details of actual services performed.

(2) Invoices or billings submitted by consultants, including sufficient detail as to the time expended and nature of the actual services provided.

(3) Consultant work products and related documents, such as trip reports indicating persons visited and subjects discussed, minutes of meetings, and collateral memoranda and reports.

b. Although auditors may not substitute their judgment for the explicit documentation requirements in a. above, auditor judgment remains important for determining if the evidence provided in each of the three categories is adequate. In order to reach a well reasoned audit conclusion on professional and consultant service costs, auditors must have sufficient and relevant evidence to determine the nature and scope of the work actually performed.

c. The third category of required evidence (7-2105.2a.(3)) is intended to provide support for the work actually performed by the consultant (in contrast to the first category of evidence regarding the work planned to be performed). Although a work product usually satisfies this requirement, other evidence may also suffice. If the contractor provides sufficient evidence demonstrating the nature and scope of the actual work performed, the FAR 31.205-33(f)(3) requirements are met even if the actual work product (for example, an attorney's written advice to the contractor) is not provided. The auditor should not insist on a work product if other evidence provided is sufficient to determine the nature and scope of the actual work performed. If the contractor refuses to provide the work product and the auditor cannot determine the nature and scope of actual work performed by reviewing other supporting documents provided by the contractor, the auditor should question the costs as unallowable under FAR 31.205-33(f). The auditor should note in the report that the evidence provided was insufficient to conclude that the work preformed was for an allowable purpose.

d. The contractor is responsible for producing adequate evidential matter to support the claimed costs. If the auditor determines that the claimed costs require additional support, then he or she should notify the contractor as to the additional data required. The auditor should provide the contractor with a reasonable period of time to respond. If the contractor fails to respond within this period, the costs should be questioned as expressly unallowable per FAR 31.205-33(f). The auditor should not attempt to obtain the additional data by

requesting attorneys, consultants, or government personnel to prepare statements of work.

7-2105.3 Allowability of Costs and Audit Considerations

Auditors should consider expressly unallowable activities specified in FAR 31.205-33 as well as the provisions in other cost principles in determining the allowability of professional and consultant service costs.

a. FAR 31.205-33(c) lists four expressly unallowable activities.

(1) Services to improperly obtain, distribute, or use information or data protected by law or regulation (FAR 31.205-33(c)(1)).

(2) Services that are intended to improperly influence the contents of solicitations, the evaluation of proposals or quotations, or the selection of sources for contract award (FAR 31.205-33(c)(2)).

(3) Any services performed or otherwise resulting in violation of any statute or regulation prohibiting improper business practices or conflicts of interest (FAR 31.205-33(c)(3)).

(4) Services performed which are not consistent with the purpose and scope of the services contracted for or agreed to (FAR 31.205-33(c)(4)).

b. Professional and consultant service costs may be unallowable under the provisions of other cost principles, including:

(1) Costs contingent upon recovery from the government (FAR 31.205-33(b)).

(2) Costs of planning or executing organization and reorganization (FAR 31.205-27(a)(1)).

(3) Costs of resisting or planning to resist a reorganization (FAR 31.205-27(a)(2)).

(4) Costs of raising capital (FAR 31.205-27(a)(3)).

(5) Costs of financing and refinancing operations, preparation of prospectuses, and preparation and issuance of stock rights (FAR 31.205-20).

(6) Costs related to bad debts (FAR 31.205-3).

(7) Costs related to legal and other proceedings (FAR 31.205-47).

(8) Reasonableness (FAR 31.201-3).

(9) Allocability (FAR 31.201-4).

c. Costs incurred by employees or officers of the contractor for purposes which are similar to those classified as unallowable by FAR 31.205-33 are also unallowable even though that cost principle specifically applies to outside professionals and consultants. FAR 31.204(c) provides that the failure to include any item of cost does not imply that it is either allowable or unallowable. This determination is to be based on the overall principles and standards set forth in the FAR and the treatment of similar or related selected items. Under that rule, a cost is unallowable if incurred by the performance of an outside service, then the cost of similar work performed in-house is also unallowable.

7-2106 Capital Items as Contract Costs

a. Contractors sometime include the unamortized value of capital equipment in contract cost presentations. For items other than approved special tooling, machinery, or equipment, and in the absence of specific contractual coverage, the auditor will question costs of capital items (See also FAR Part 45).

b. Special Tooling and Special Test Equipment. The cost of special tooling and special test equipment (as defined in FAR 45.101a) used in performing one or more government contracts is allowable and shall be allocated to the specific government contract or contracts for which acquired (FAR 31.205-40). In auditing costs for special tooling or test equipment, determine if such items are properly classified and authorized under the contract. (See FAR 45.306, Special Tooling and FAR 45.307, Special Test Equipment). Unauthorized or otherwise inappropriate charges for this type of item may be misclassified in detailed cost accumulations such as for material, supplies, or miscellaneous in-house work orders for fabrication, production support, or maintenance (see 9-602). The auditor will use the government property administrator's review data and evaluation reports, and should request technical assistance to review any observed or suspected deficiencies (See 14-400).

7-2107 Employee Termination Payments

7-2107.1 Termination Plans, Early Retirement Incentives, and Severance Payments

a. A termination plan sets out the criteria used by a contractor to terminate its employees and determines the termination compensation to be paid to those employees.

b. A special termination plan uses different criteria than the contractor's normal established criteria or provides different benefits than its normal established benefits. Special termination plans are used for unusual circumstances such as the requirement to make mass terminations or a goal to make significant reductions in the company's work force. In such situations, employers have found it advantageous to provide incentives for employees who "volunteer" to be terminated. The employer can design these plans to limit the employees eligible for termination as well as steer employees who would be the best choices from the employer's viewpoint toward "volunteering."

c. Early retirement incentive payments are payments made pursuant to a plan offered exclusively to employees eligible to retire under a pension plan. The purpose of such plans is to induce eligible employees to make an election to retire early and receive immediate pension benefits. Early retirement incentives are sometimes included within a termination plan. If included in a termination plan, the early retirement incentive policy and procedures must meet the same requirements as if it were a separate plan. (For further discussion of early retirement incentive payments, see 7-608.) FAR 31.205-6(j)(7) limits the allowable amount of the early retirement incentive payment to the employee's annual salary for the last contractor fiscal year completed prior to the employee's retirement.

d. Severance pay, also commonly referred to as dismissal wages, is defined in FAR 31.205-6(g) as a payment, in addition to regular salaries and wages, to workers whose employment is being involuntarily terminated. If a contractor makes a severance pay plan available to its employees regardless of their retirement eligibility, the payments from that severance plan are allowable if they are reasonable and in accordance with FAR 31.205-6(g). The payments made under a severance pay plan to employees who, coincidentally, are also eligible for pension benefits should not be reclassified and treated as early retirement incentive payments subject to FAR 31.205-6(j)(7).

e. The auditor should closely review the reasonableness of special termination plans that offer both severance-type benefits and early-retirement-incentive-type benefits to the same employee. A well designed special termination plan usually does not need to offer both of these benefits to the same employee to achieve its goals to reduce levels of employment. Usually, if both types of benefits are included in the plan, the employee can choose one of them, but not both. However, the actual determination of allowability must be made considering the reasonableness of the entire termination plan (see 7-2107.7).

7-2107.2 Severance Pay Benefits

Contractors usually have a severance pay policy that pays employees a set number of weeks' pay based upon years of service. However, some contractors may provide additional termination benefits, such as medical care, education, and relocation expenses in order to reduce hardship to employees terminated as the result of a mass work force reduction process. These additional benefits also represent severance pay. The allowability of the total severance pay is subject to the reasonableness criteria contained in paragraph (b) of FAR 31.205-6, Compensation for personal services. Note that FAR 31.205-6(b) requires the contractor to demonstrate reasonableness of compensation items. It specifies factors to be considered in determining reasonableness, including the compensation practices of other firms in the same industry as well as the practices of firms engaged in non-government work.

7-2107.3 Payments for Involuntary versus Voluntary Terminations

FAR 31.205-6(g) provides that severance pay is a payment, in addition to regular salaries and wages, to workers whose employment is being involuntarily terminated. This provision can be applied to both of the following situations. First, "involuntarily terminated" can refer to situations where the employee has no option of staying with the company. Secondly, "involuntarily terminated" can refer to situations where the contractor has an established goal for a reduction in work force. Whether or not any specific employee is given an option to stay is irrelevant, provided that the contractor has an established goal. The contractor's commitment to a work force reduction may be evidenced by providing assurance to the government that the terminated employees will not be replaced; i.e., their jobs have been abolished in order to reach the established goal. Reductions in the work force made under this second situation are often accomplished under special termination plans and may produce higher termination costs than would the contractor's previously established termination benefits. The higher costs are allowable if reasonable (see 7-2107.7). Payments made for involuntary terminations are allowable subject to the provisions contained in FAR 31.205-6, while payments made for voluntary terminations are unallowable.

7-2107.4 Normal and Abnormal Severance Pay

a. FAR 31.205-6(g)(2) classifies severance pay as either normal or abnormal. Either is allowable only to the extent that in each case it is required by (1) law; (2) employer-employee agreement; (3) an established policy that constitutes, in effect, an implied agreement on the contractor's part; or (4) the circumstances of the particular employment.

b. Normal severance pay should be allocated to all work performed in the contractor's plant. When the contractor provides for accrual of pay for normal severances, such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made for normal severances over a representative past period and if the amounts accrued are allocated to all work performed in the contractor's plant.

c. Abnormal or mass severance pay is considered by FAR 31.205-6(g)(2)(iii) to be of such a conjectural nature that measurement of costs by means of an accrual will not achieve equity to both parties. Accruals for abnormal or mass severance pay are not allowable. However, when specific payments occur, allowability will be considered on a case-by-case basis. Severance paid under the terms of a special termination plan is generally abnormal severance.

7-2107.5 Severance Pay When There Is a Replacement Contractor

Severance payments made to employees who are to be employed by a replacement contractor are not allowable. For this purpose, employment by a replacement contractor occurs when continuity of employment with credit for prior length of service is preserved under substantially equal conditions of employment, or continued employment by the contractor at another facility, subsidiary, affiliate, or parent company of the contractor.

7-2107.6 Severance Paid in Addition to Early or Normal Retirement Benefits

a. Prior to October 3, 1988, FAR 31.205-6(g)(2)(i) provided that severance payments, or amounts paid in lieu of, are not allowable when paid to employees in addition to early or normal pension payments.

b. The prohibition of payment of both severance and pension benefits was deleted by Federal Acquisition Circular 84-39 effective October 3, 1988. The FAR now permits the payment of otherwise allowable severance and pension benefits concurrently, as well as sequentially, i.e., in the latter case, the contractor may delay payment of pension benefits until after the period for which severance pay is provided. In the circumstances where the contractor provides payment of both severance and pension benefits to the same employee,

the auditor needs to closely review the plan to determine if the total plan costs are reasonable.

7-2107.7 Reasonableness of Special Termination Plan Costs

a. Contractors may offer special termination plans, which provide enhanced benefits, to achieve a work force reduction goal by inducing voluntary employee terminations. The rationale behind offering an enhanced severance payment, or an early retirement incentive, should be that the contractor will achieve lower overall costs which will offset the higher termination costs of the special plans. The costs of such plans could include loss of key personnel, higher severance costs (e.g., increased severance benefits for each employee class when compared to the normal plan and higher severance costs resulting from senior workers volunteering to terminate), and higher pension costs resulting from primarily the early retirement incentives. The primary cost reductions of such plans generally are lower overall compensation of the remaining employees, as well as reductions in recruiting and training needs in the near-term. For example, by inducing older employees to retire, the contractor retains younger, fully trained employees who will not need to be replaced for a longer period of time and who are likely to be paid less than the terminated workers.

b. The contractor should be able to support a special termination plan with sufficient information to make a determination that the additional costs incurred by the special plan are offset by associated additional reductions in other costs. Both FAR 31.205-6(b)(1) and 31.201-3 require a contractor to demonstrate that its plan is reasonable.

c. In assessing the reasonableness of a plan, the auditor should consider the value of intangible benefits associated with employee morale and the contractor's reputation as an employer. However, there is no presumption that the government will allow the costs of such intangible benefits. If justification for a special plan is based on the value of intangibles, it would be an appropriate subject for an advance agreement with the government before the cost is incurred. (See FAR 31.109 for further discussion of advance agreements.) If the cost/benefit analysis includes intangible benefits and no advance agreement was executed, the auditor should discuss this matter with the contracting officer. If it is decided that the intangible items should be included in the cost/benefit analysis, the auditor should evaluate the reasonableness of the values assigned to those items. The auditor should question any unreasonable costs associated with the plan.

7-2107.8 Golden Parachute Plans

a. A "golden parachute" is a termination agreement which provides for the payment of extremely lucrative financial benefits, usually to a limited number of key executives. The termination or severance payments granted under the "golden parachute" arrangement are normally well in excess of normal severance payments. Such payments are paid only in the event the employee leaves the company following an actual or anticipated corporate merger or a transfer of control over the company. A common motivation for instituting a "golden parachute" plan is to discourage a hostile takeover by making the costs of a takeover prohibitively expensive.

b. The costs of "golden parachutes" were made expressly unallowable in FAR 31.205-6(l)(1) effective April 4, 1988. Costs of "golden parachutes" are not reasonable, do not benefit the government, and constitute costs incidental to reorganization because such agreements become operative only with the actual or anticipated corporate takeover. Accordingly, the auditor should also question costs of "golden parachutes" claimed by the contractor for contracts awarded prior to April 4, 1988 based on the cost principle provisions for reasonableness (FAR 31.201-3 and 31.205-6), allocability (the benefits received requirement at FAR 31.201-4), and organization costs (FAR 31.205-27). For costs of "golden parachutes" included in any billing, claim, or proposal submitted by the contractor for contracts awarded on or after April 4, 1988, the auditor should

cite FAR 31.205-6(l)(1) as a basis for disallowing such costs. See also 7-1708.

7-2107.9 Severance Pay to Foreign Nationals

a. Effective March 29, 1989, service contracts to be performed outside the United States included the clause at FAR 52.237-8. The clause limits severance paid to foreign nationals performing services outside the United States to the amount typically paid to employees providing similar services within the United States. Effective February 19, 1993, this coverage was removed from FAR 31.205-6, 37.110, and 52.237-8, for non-DoD contracts. This coverage was included in DFARS 231.205-6, effective October 30, 1992, for DoD contracts.

b. Effective December 21, 1990, the clause at FAR 52.237-8 was revised to make such severance payments totally unallowable for terminations of employment resulting from requests of the host foreign government to close or curtail the employing activity. This prohibition of severance payments only applies to terminations of agreements between the United States and the host country entered into after November 28, 1989. Effective February 19, 1993, this coverage was removed from FAR 31.205-6, 37.110, and 52.237-8, for non-DoD contracts. This coverage was included in DFARS 231.205-6, effective October 30, 1992, for DoD contracts.

c. The Defense Appropriations Act of 1992 (Section 346) allows DoD to waive the limitations on allowability of severance payments to foreign nationals for contracts for the operations of overseas military banking services.

7-2107.10 Severance Pay Policies for Paid Absences Under the Worker Adjustment and Retraining Notification (WARN) Act

a. The Worker Adjustment and Retraining Notification Act (WARN), sometimes called the Federal Plant Closure Law, 29 U.S.C. 2101, applies to employers with 100 or more full-time employees or to employers with 100 or more employees who in the aggregate work at least 4,000 hours per week (exclusive of overtime). The Act requires that employees be provided with a 60-day advance notice when a plant is to be closed or there is to be a mass layoff. A plant closure is defined as a permanent or temporary shutdown of a single site of employment, one or more facilities, or an operating unit, where 50 or more employees (excluding part-time employees) lose their jobs. A mass layoff is defined as a reduction in force which is not a plant closing but which results in at least 33 percent of the work force (with a minimum of 50 employees) or 500 employees being terminated (excluding part-time employees).

b. The WARN Act allows employers to give notice to employees less than 60 days in advance when a business circumstance is such that it is not reasonably foreseeable at the time that the 60 day notice would have been required. In order to be not reasonably foreseeable, the event must be caused by a sudden, dramatic, and unexpected action or condition outside the employer's control.

c. A contract termination may result in a plant closure under the Act if it causes the shutdown of at least one site, facility, or operating unit. Shutdown of an operating unit will occur when there is the discontinuance of an entire product line or the extinction of an organizationally distinct operation or function. The critical factor in determining what constitutes an operating unit will be the organizational or operational structure of the contractor. The circumstances of each contract termination should be reviewed and evaluated to determine if the contract termination resulted in a plant closure under the Act.

d. Where a contract termination results in a plant closure, and the contractor has exercised reasonable and prudent efforts in providing timely notification of the plant closing, costs incurred to comply with the WARN Act are generally considered allowable and reasonable business expenses under FAR 31.201-2 and 31.201-3.

e. Where the termination does not meet the provisions of the WARN Act, the auditor should determine if the contractor's actions were reasonable. For example, if the contractor terminates less employees than the minimum required for application

of the WARN Act, any payments made for unproductive effort should generally be questioned as not meeting the test of payments for work accomplished in the current year. However, such payments would be allowable to the extent that the contractor can demonstrate that, given the circumstances at the time, it was reasonable to give the WARN Act notices and make the associated payments to the affected employees.

f. In some instances, contractors may place WARN Act status employees who are in sensitive positions on paid absence because of fear that those employees, if allowed to work during the 60-day period, might use their positions to harm the contractor's assets or records in retaliation for losing their jobs. There is no existing regulation or policy which specifically prohibits payments for such paid absence. The paid absence during the 60-day notice period could be considered additional severance pay. However, the contractor may claim the costs as some other category of cost associated with the reduction in force. FAR 31.205-6(b) requires that the contractor demonstrate reasonableness of compensation items and FAR 31.201-3 requires the contractor demonstrate the reasonableness of all costs claimed. Therefore, it is incumbent upon the contractor to demonstrate why it believes the employees are a high risk and should not be working during the notice period. The contractor must also explain why these employees cannot be reassigned to perform nonsensitive work elsewhere in the plant and what the contractor's policy and procedures are in this situation. Without acceptable justification from the contractor, any claimed costs for paid absence during the 60-day notice period would be considered unreasonable and should be questioned.

7-2108 Industrial Security/Plant Protection Costs

a. The provisions of FAR 31.205-29, Plant Protection Costs, state that costs of protecting the contractor's plant and other property are allowable. The costs of items such as (1) wages, uniforms and equipment of personnel engaged in plant protection, (2) depreciation on plant protection capital assets, and (3) necessary expenses to comply with military requirements, are allowable provided they are reasonable and allocable.

b. There are now a number of commercial companies that provide plant security protection services, including well-trained uniformed guards. These security service companies often provide efficient plant protection services for less than the cost of such services performed by the contractor's own security employees. Accordingly, evaluation of costs of security guards at the contractor's facilities should include a comparison between the cost of the in-house services and the cost of engaging an outside security service firm. When excessive or unreasonable costs are questioned as a result of the above cost comparison, it is the contractor's responsibility to demonstrate the reasonableness and to justify the costs (see FAR 31.205-6(b)(1)).

7-2109 Correction Costs for Internal Control Deficiencies

An internal control system comprises the plan of organization and all of the coordinated methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. Internal controls extend to functions other than those relating to accounting controls; e.g., performance reports, employee training programs, and quality controls (see 5-107). This subsection provides guidance relating to the costs of correcting deficiencies in internal control systems or excessive costs that result from the lack of effective internal controls.

7-2109.1 Correction Costs of Quality Control Program Deficiencies

a. Purpose of Quality Control. Effective contractor quality control or product assurance systems provide systematic control of quality and reliability in all phases of the operation including design, procurement, production, testing, storage, and handling of materials. Quality assurance systems consist of both quality control and

inspection. The quality control system is responsible for maintaining the quality of the product within established standards. Inspection is a sorting process that classifies material, parts, or products as acceptable or unacceptable. As quality control becomes increasingly effective, the need for inspection correspondingly decreases. Weaknesses in or lack of effective control can result in:

(1) Inadequate products or services;

(2) Unnecessary and ineffective use of resources, including labor, material, and equipment;

(3) Unreliable and inadequate analysis of quality assurance requirements and inspection results;

(4) Unnecessary inspections and work stoppages;

(5) Unreliable management reporting systems;

(6) Unnecessary administrative effort; and

(7) Unreliable test equipment.

b. Allowability of Costs.

(1) The cost of maintaining an acceptable quality control system is allowable, if reasonable. Where minor deficiencies are cited by the government, making corrections to the system should be considered to be part of maintaining an acceptable quality control system and related costs are allowable. However, where significant corrections to the quality control system are needed because of the contractor's earlier negligence in establishing and/or maintaining acceptable controls, an unreasonable amount of increased costs to the government would result through duplicative efforts to reinstitute a quality control program. These costs should be disallowed on a basis of reasonableness (FAR 31.201-3).

(2) FAR 46.311 requires certain contracts to contain the contract clause at FAR 52.246-11, Higher-Level Contract Quality Requirement (Government Specification). This clause requires contractors' compliance with the specified government quality control specification requirements. Where this clause is contained in a contract, the contractor has a contractual obligation to establish and maintain a quality control program to assure adequate quality throughout all areas of contract performance, including design, development, fabrication, processing, assembly, inspection, test, maintenance, packaging, shipping, storage, and site installation. In these situations, the contract clause provides a contractual mechanism for requiring contractor corrective actions at no increased cost to the government. Where a contractor is in violation of the government quality requirements specified in a solicitation, a comment should be included in DCAA audit reports indicating that contract award should not be made until the deficiencies are corrected by the contractor. In addition, where contractor deficiencies are cited on existing contracts, the auditor should recommend the use of advance agreements for limiting government liability and segregation of the costs of correcting quality control system deficiencies (to allow audit visibility). If the contractor refuses to segregate these costs, recommend suspension of payment until proper accounting and segregation of costs are made.

7-2109.2 Costs Related to Extraordinary Reviews of Unsettled Overhead Costs

a. All contractors doing business with the government are required by FAR 31.201-6 to have adequate internal controls to assure that unallowable costs are not included in billings and claims submitted to the government. Some contractors may undertake large-scale reviews of unsettled overhead costs to identify unallowable costs that may have not been segregated and removed from overhead claims during the original processing of the transactions and/or the initial preparation of the billings or claims. This extraordinary effort is often the result of the contractor's earlier negligence in establishing, maintaining, and/or implementing an adequate system of internal control.

b. When the circumstances cited in paragraph a. above are encountered and the contractor is incurring or is expected to incur significant costs, the auditor should notify the contractor that the costs associated with such extraordinary reviews of unsettled overhead costs are considered to be unreasonable and will be questioned under FAR 31.201-3, Deter-

mining reasonableness. The reasons to be cited are:

(1) The costs are not of a type generally recognized as ordinary and necessary for the conduct of the contractor's business or the performance of a contract. The costs are duplicative of costs incurred for the same purpose in prior periods. The government has already reimbursed the contractor for the costs of preparing billings and claims for reimbursement. The fact that this task was not adequately accomplished does not entitle the contractor to additional reimbursement.

(2) The costs are the result of the contractor's failure to follow the requirements of generally accepted sound business practices and contract terms.

(3) The costs result from actions taken which were not those of a prudent businessman in the circumstances, considering his responsibilities to the owners of the business, his employees, his customers, the government, and the public at large.

7-2109.3 Costs Related to Contractor Self Governance Programs

Contractor activities under self-governance programs are to be encouraged as a matter of DoD policy. Costs of such activities are allowable if reasonable in amount.

7-2110 Bank and Purchase Card Transaction Fees

a. Administrative costs associated with short-term borrowings for working capital may be classified as “bank fees.” These administrative costs are allowable under FAR 31.205-27, Organization costs.

b. Many contractors allow purchasers, including the government, to pay for purchases through the use of a purchase card (such as the IMPAC card). When a contractor accepts a purchase card for payment of goods and services, the contractor is charged for transaction costs, generally referred to as “merchant fees”. Merchant fees include fees paid by the contractor to the contractor’s bank, the credit card company (i.e., VISA or MasterCard), and the card-issuing bank for processing payment through the credit card network. Auditors should not assume these fees represent unallowable interest costs merely because the fee is usually expressed as a percentage of the amount of the transaction. The transaction fees associated with the use of the purchase card represent a charge for administrative processing and do not represent interest on borrowings.

c. Some banks offer financial agreements which grant lines of credit at less than the prime interest rate. The bank may classify this difference as a bank fee which the contractor may be claiming as an allowable cost under government contracts. However, the difference between the agreement’s rate and the prime rate should be considered unallowable under FAR 31.205-20, Interest and other financial costs, which specifically disallows interest on borrowings, however represented. Accordingly, bank fees claimed by contractors should be carefully reviewed to determine whether they are, in fact, interest costs.

d. Where contractors have entered into agreements similar to that discussed in paragraph c. above, and claim the costs under government contracts, the procedures in 4-702 should be followed as applicable.

7-2111 No Cost Storage Contracts

7-2111.1 Definition

No Cost Storage Contracts are contracts for which the contractor is to provide the government with storage or warehousing services, but payment of the costs associated with these services is not provided for in the contracts. Some of these contracts specify that storage or warehousing costs are to be charged as an indirect expense. Other such contracts, while not specifically stating that the storage or warehousing costs are to be charged indirect, make no provision for reimbursement of such costs under the contract. The likely result is that the costs associated with the storage or warehousing are allocated to and reimbursed under other non-benefiting government contracts.

7-2111.2 Audit Considerations

a. Allocability of Costs. The provisions of FAR 31.201-4, Determining Allocabil-

ity, and CAS 418 set forth criteria for determining the proper allocation of expenses to final cost objectives. Irrespective of whether a contract provides for reimbursement of costs of particular items, the allocability of costs must be determined by the casual or beneficial relationship of the cost to the final cost objectives. Other contracts cannot bear the storage or warehousing costs that are properly allocable to the No Cost Storage Contracts (see 6-606 and 8-418).

b. Consistency in Accounting Treatment of Costs. FAR 31.202, Direct Costs, and CAS 402 state that all costs incurred for the same purpose in like circumstances, are either direct costs only or indirect costs only with respect to final cost objectives. A noncompliance with FAR 31.202 and CAS 402 arises when some contracts are charged directly for storage costs, as well as indirectly for the storage costs that should have been charged to the No Cost Storage Contracts. Inconsistent accounting treatment of storage or warehousing expense should be reported as a noncompliance with these requirements (see 6-608.3 and 8-402).

c. Anticipated Awards of No Cost Storage Contracts. When an ACO, PCO, or commercial customer has requested the contractor to store property at no cost, the auditor should place the ACO and/or PCO, and the contractor on notice that the cost associated with the storage or warehousing should be allocated in accordance with the contractor's normal accounting practices and the criteria discussed in paragraphs a. and b. above. If necessary, discuss the issues with the cognizant ACO so that a written notice of intent to disallow costs on impacted contracts may be issued in accordance with FAR 42.8.

d. Active No Cost Storage Contracts. Where auditors identify No Cost Storage Contracts, any inappropriate allocation of costs should be questioned. If not already issued, appropriate CAS and/or FAR noncompliance reports and DCAA Forms 1, if applicable, should be issued. In these situations, the contractor may assert that the audit position would involve prejudicial retroactivity and may introduce estoppel as a defense. The validity of an asserted estoppel claim is a legal issue and the auditor should not attempt to resolve such arguments. Estoppel is a matter which normally should be considered by contracting officers and procurement counsel subsequent to the issuance of the audit results. However, if an auditor perceives that an estoppel issue may affect an audit, the matter should be referred to the Regional Director for appropriate legal consultation.

7-2112 Banked Vacations

7-2112.1 General

a. The term "banked vacations" refers to a situation where contractors have policies that allow employees to carry forward and accumulate (bank) all or a portion of vacation time not taken within the year in which entitlement is earned. The banked vacation can be taken at a later date or not taken at all, in which case payment for the amount of banked vacation time is usually made when the employee terminates employment. Sometimes contractors write up the vacation liability on the books to reflect employees' pay raises received subsequent to the periods in which vacation was earned.

b. CAS 408 does not address the practice of banking vacations, nor does CAS 415 specifically apply to compensated absences. Therefore, auditors should not issue CAS 408 or CAS 415 noncompliances because of problems with the contractors' policies/practices regarding banked vacations.

7-2112.2 Audit Considerations

a. Many contractors have ceased the practice of banking vacations, (i.e., have adopted a use-or-lose policy), or now allow deferral for only one accounting period following the year in which the vacation was earned. Nevertheless, if the situation of banked vacations exists, the auditor must first determine if the contractor's method of accounting for banked vacation accruals is proper, and then look at the reasonableness of the vacation policy and costs as a component of total compensation.

b. A contractor normally accrues vacation liability as each employee earns vacation. It is appropriate for a contractor's books to reflect the liability that will have to eventually be paid. Therefore the contractor, for financial accounting purposes, may decide to write up the vacation accruals; otherwise the accruals on the books may be understated. If banked vacation deferrals extend beyond one year and related write-ups are significant, the auditor should recommend that the ACO seek an advance agreement with the contractor establishing mutually agreeable criteria for calculating banked vacation accruals including consideration of present value methodology.

7-2113 Payments to Contractors Under the Job Training Partnership Act

a. The Job Training Partnership Act was passed by Congress to help turn the hard-core unemployed into productive wage earners. As part of that effort, local Private Industry Councils (PIC) were created to identify, counsel, train, and place unemployed people. One incentive to industry to participate in the program is a partial subsidization of these new workers' wages, up to 50 percent, for the first weeks or months of their employment. The law further specifies that these PIC reimbursements are intended to compensate employers for the increased training costs and reduced productivity associated with hiring the hard-core unemployed.

b. Contractors receiving PIC payments as part of this program should not receive duplicate reimbursements under government contracts. If the contractor includes costs in its proposals or billings that are subject to PPD reimbursement, an appropriate credit should be given to the government. Conversely, if the contractor can and in fact does exclude from its proposals or billings increased costs resulting from its participation in the PIC program, then no credit or offset is required. Such increased costs often result from additional training and supervision that are associated with hiring the hard-core unemployed as well as reduced productivity in the form of additional hours and materials required by these employees.

7-2114 Employee Stock Ownership Plans (ESOPs)

7-2114.1 General

a. An Employee Stock Ownership Plan (ESOP) is an individual stock bonus plan designed specifically to invest in the stock of the employer corporation. An ESOP may be either nonleveraged or leveraged.

b. An Employee Stock Ownership Trust (ESOT) is the entity responsible for administering the ESOP. The contractor's contributions to the ESOT may be in the form of cash, stock, or property.

c. Under a nonleveraged ESOP, annual contributions are made by the corporation to the ESOT in the form of stock, property, or cash. If the contribution is in the form of cash, the ESOT uses this cash to acquire company stock. The ESOT holds the stock for the employees and periodically notifies them of how much they own and how much it is worth. The employees receive the stock (or the cash equivalent) when they retire or otherwise leave the company (depending upon the provisions of the ESOP).

d. Under a leveraged ESOP, the ESOT borrows money from the bank and then uses these funds to make a large purchase of company stock, either from the shareholders or from the company, e.g., treasury stock. This stock then becomes collateral for the bank loan. Each year the company makes a contribution to the ESOT equal to the total amount of the principal and interest on the loan. The ESOT then uses this money to make its annual payment to the bank. Upon receipt of the ESOT loan payment the bank releases an amount of stock in proportion to the loan principal paid by the ESOT. The released stock is then distributed by the ESOT to the accounts of the plan participants in accordance with the provisions of the plan. The employees receive the stock (or the cash equivalent) when they retire or otherwise leave the company (depending upon the provisions of the ESOP).

7-2114.2 Pension Versus Deferred Compensation ESOPs

a. For a plan to be a pension ESOP, the official plan documents must offer the plan participants:

(1) benefit payments for life or

(2) benefits that are payable for life at the option of the participants. Some contractors may contend that a pension ESOP exists where there is no official plan provision for life payments, because the contractor has made some informal provisions to cash in the employee's stock and purchase an annuity for the employee. Such informal provisions are not enough to meet the "payable for life" requirement for pension plans, nor are these informal provisions enforceable by the employee.

b. Plans that provide future payments for current work, and that are not pensions, are deferred compensation ESOPs.

7-2114.3 Applicable FAR/CAS

a. The reasonableness of all ESOP costs must be supported in accordance with FAR 31.205-6(a) and (b). In assessing the reasonableness, the auditor should review the terms of the ESOP to determine if the plan design provides unreasonable compensation to certain employees or groups of employees. In addition, the reasonableness of the amount of stock distributed to employees should be reviewed in conjunction with a review of the employees' total compensation (see 5-800).

b. Under leveraged ESOPs, for any given period the shares released from collateral under the terms of the loan may exceed the number of shares to be allocated under the terms of the plan. The auditor should be alert to excess shares that might be awarded to ESOP participants and claimed by the contractor. In the absence of the Contracting Officer's prior approval, the award of excess shares to ESOP participants should be questioned, since the excess shares are not awarded according to the established compensation plan.

c. Contractor contributions to a pension ESOP must meet the requirements of CAS 412 and FAR 31.205-6(j), while contributions to a deferred compensation ESOP are subject to the requirements of CAS 415 and FAR 31.205-6(k).

d. FAR 31.205-6(j)(8) specifically addresses the allowability of pension ESOP costs. For pension type ESOPs, interest costs incurred by the trust are allowable provided the contractor’s annual contribution to the ESOT meets general reasonableness criteria and the specific limitations in subparagraph (j)(8) of the cost principle, e.g., contributions may not exceed 15 percent (25 percent with a money purchase plan) of employee salary and wages. FAR 31.205-6(j)(8)(E) limits the allowability of cash contributions used by the ESOT to purchase stock. The amount of the price paid for the stock in excess of its fair value, and the interest applicable to the excess price are unallowable. Contractor’s cash contributions (principal and interest) attributable to the excess price should be questioned pro rata during the loan repayment period.

e. CAS 415.50(e)(1) requires that the cost of deferred compensation awards, when such awards are made in the stock of the contractor, shall be based on the market value of the stock on the measurement date, i.e., the first date the number of shares are known. For deferred compensation ESOPs, the date the contractor transfers the stock to the ESOT or pledges the stock as loan collateral on behalf of the ESOT is the first date that the number of shares awarded is known. Thus, for leveraged ESOPs, costs assignable to a cost accounting period will be the fair market value of the stock on the date the contractor transfers the stock to the ESOT or pledges the stock as loan collateral on behalf of the ESOT, multiplied by the total number of shares actually earned for that period.

7-2114.4 ESOP Stock Valuations

a. The auditor should perform audit tests to determine that the contractor is not reimbursed an amount exceeding the fair market value of the stock on the measurement date. Where a leveraged buyout is involved, the price per share immediately after the buyout represents the value of the stock to be distributed to contractor employees. As such, the fair market value of

the stock should be based on the contractor's debt/equity structure immediately after the buyout.

b. For stock that is publicly traded in substantial quantities, the published trading price on the measurement date should reflect the fair market value of the stock. For companies where the stock is not publicly traded in substantial quantities, a valuation is required. The annual appraisal of the ESOP stock should serve as the baseline for the auditor's review.

c. Valuation of stock for a company that is not publicly traded in substantial quantities is a complex process. While there is no formula that can be applied to all circumstances, the auditor should determine if the data used in making the valuation is current, accurate, and complete, and if the assumptions underlying the valuation are reasonable. In addition, the auditor should determine if appropriate adjustments have been made to reflect minority interests and/or lack of marketability.

d. Discount for Minority Interest - The discount for minority interest represents the additional cost per share needed to obtain a majority (control) interest divided by the majority cost per share. The fair market value of the ESOP stock should include a discount to reflect a minority interest whenever the ESOT has not purchased a controlling interest in the company, i.e., the ESOT cannot exercise control over company decisions. A discount may also be appropriate even when the ESOT has purchased a majority of the company stock, if circumstances are present which prevent the ESOT from effectively exercising meaningful control, e.g., the ESOP trustee exercises significant voting rights and is not independent of the company. The decision to apply a minority discount in such situations must be made on a case-by-case basis. The decision should consider all relevant factors including the fiduciary responsibility of the trustee which may mitigate the lack of independence.

(1) Where the ESOP stock has been obtained as part of a buyout, the additional cost can generally be computed by taking the difference between the actual cost paid per share and the value of the stock prior to any knowledge or speculation (e.g., leaks or rumors) of the upcoming buyout. This value must be close enough in time to be relevant to the buyout (preferably one or two months) but should not be a time period in which there were significant events that led to changing market conditions (e.g., stock market crash or product boycott).

(2) Where a leveraged buyout is not involved, the discount should be based on historical data regarding similar companies that have been bought or sold within a relevant time period. If no such data exists, then overall market information may be used.

e. Discount for Lack of Marketability - Where the stock is not publicly traded, it should generally be discounted to reflect its lack of marketability. A marketability discount reflects the fact that the stock of a closely held company is generally less attractive to potential investors than publicly traded stock.

(1) Even when the company has always exercised its option to repurchase the stock, or where the plan requires the company to repurchase the stock (called "put" rights), some discount will usually apply. While the amount of the marketability discount will differ depending upon the specific circumstances involved, such discounts have generally ranged from 5 to 20 percent.

(2) Factors that influence the amount of the marketability discount include the extent to which "put" rights are enforceable, the company's ability to meet its obligations with respect to these "put" rights (taking into account the company's financial strength and liquidity), the company's history of redeeming its ESOP shares for cash when tendered, and the establishment of a funding program for the repurchase liability.

7-2114.5 Allowability of ESOP Interest Costs Incurred Before January 1, 1994 and Costs Associated with Valuation of ESOP Stock Incurred Before January 1, 1995

a. Section 844 of the Defense Authorization Act for 1998 provides a “sense of Congress” regarding the allowability of ESOP interest costs incurred before Janu-

ary 1, 1994 and the allowability of costs associated with valuation of ESOP stock of closely held companies for costs incurred before January 1, 1995. The Department of Defense adopted the "sense of Congress" by providing guidance on the treatment of applicable ESOP costs in a January 22, 1998 memorandum issued by Director, Defense Procurement. The special treatment does not affect ESOP costs incurred after those dates. Auditors should continue to follow the applicable paragraphs of 7-2114 for those audits.

b. The special treatment regarding the allowability of interest cost applies only to deferred compensation ESOPs that are leveraged. Auditors should not disallow ESOP costs that meet both of the following conditions: (1) Costs were included in incurred cost proposals submitted prior to November 18, 1997; and (2) costs were incurred before January 1, 1994. For interest costs incurred after January 1, 1994, auditors should apply CAS 415 criteria to measure and assign the cost of deferred compensation ESOPs (see 7.2114.3e.).

c. The special treatment regarding the allowability of costs associated with valuations of ESOP stock of closely held companies applies to both pension and deferred compensation ESOPs. Auditors should not disallow costs related to ESOP debt, control premiums, or marketability discounts associated with the valuation of ESOP stock of closely held companies, if the costs meet both of the following conditions: (1) Costs were included in incurred cost proposals submitted prior to November 18, 1997; and (2) costs were incurred before January 1, 1995. For costs incurred after January 1, 1995, auditors should evaluate the ESOP stock in accordance with 7-2114.4 above.

d. Prior positions taken by the government before January 1, 1994 for ESOP interest costs and before January 1, 1995 for ESOP stock valuations need not be changed. Evidence of a prior government position is an audit report that questioned the costs, a Form 1 that disallowed the costs, or a contracting officer decision stating the costs were unallowable.

e. The special allowability treatment does not supersede any agreement already entered into between the government and the contractor providing for a different treatment of ESOP costs.

7-2114.6 Dividends Used To Satisfy ESOP Contribution Requirements for Leveraged ESOPs

a. Tax regulations allow companies with leveraged ESOPs to deduct dividend payments used to service ESOP debt, including dividend payments applicable to stock that has been allocated to employee accounts (allocated stock), as well as dividend payments applicable to stock held by the employee stock ownership trust (unallocated stock). As a result, some companies use the dividends applicable to allocated, unallocated, or both allocated and unallocated stock to satisfy their annual ESOP contribution requirements.

b. Dividend payments that relate to stock that has been allocated to employee accounts on or before the dividend date of record are unallowable because they arise from ownership of the stock rather than compensation for services rendered. This is the case regardless of whether the dividends are paid directly to the employees, credited to employee accounts, or used to service the ESOP debt, or used to acquire additional shares. Since such dividend payments do not represent remuneration for services rendered, they do not meet the requirements for compensation under CAS 415 or FAR 31.205-6.

c. Allowable ESOP costs are equal to the fair value of the stock allocated to employee accounts in the current year, less the amount of dividends applicable to the shares that have been allocated to employee accounts on or before the dividend date of record (Figure 7-21-1). Schedule E (Form 5500) of the contractor's annual tax return identifies dividends used to service ESOP debt for allocated and unallocated stock.

Figure 7-21-1
ESOP Dividend Example

1. Assumptions:

Dividends Used to Satisfy ESOP Contribution Requirements	$60,000
Dividends Related to Allocated Shares	$25,000
Dividends Related to Unallocated Shares	$35,000
Fair Market Value on Date Contractor Pledged Stock	$ 10
Shares Allocated to Employee Accounts in Current Year	10,000

2. Solution:

Under CAS 415.50, the amount of deferred compensation ESOP costs assignable to a given accounting period for a leveraged ESOP is the fair market value on the date the contractor sells, assigns, or otherwise transfers control of the stock, multiplied by the total number of shares actually earned for that accounting period (7-2114.3(d)). Thus, for this example, allowable ESOP costs would be computed as follows:

Measured Under CAS 415.50 ($10 x 10,000 shares)	$100,000
Less: Unallowable Amounts - Dividends Related to Allocated Shares (7-2114.5(b))	$ 25,000
Allowable ESOP Costs	$ 75,000

7-2115 Cooperative Research Consortium Costs

7-2115.1 Introduction

This section provides guidance for performing audits of cooperative research consortiums. This guidance is specifically targeted at partnerships, joint ventures, or corporations (referred to in this section as consortiums) formed pursuant to the National Cooperative Research Act. Guidance on other organizational structures chosen by a contractor to carry on its business or to bid on government contracts is provided in 7-1800.

7-2115.2 General

In 1984, Congress passed the National Cooperative Research Act. This act eased antitrust laws to allow companies in the same industry to jointly develop new technology. Under the Act, research and development is usually funded cooperatively to develop base technology for use by member firms individually in proprietary applications. The Act covers research and development activities up to the prototype stage. Cooperative research consortiums are usually formed to explore specific research areas.

7-2115.3 Accounting Considerations

a. While the terms and conditions of these agreements may suggest they are contracts, they are not the type of contract contemplated under FAR 31.205-18(a) that would preclude the recovery of IR&D costs. R&D costs incurred by a defense contractor pursuant to a cooperative agreement may be considered as allowable IR&D costs if the work performed would have resulted in allowable IR&D costs had there been no cooperative agreement.

b. Consortium costs will most likely be charged to indirect cost pools, primarily as Manufacturing and Production Engineering (MPE) or IR&D. The audit review of consortium costs must consider the different accounting treatment afforded MPE costs versus IR&D costs. As MPE, the costs are not subject to ceiling limitations imposed by IR&D/B&P advance agreements and are charged to the government through G&A and overhead allocations. Because the cost limitations of IR&D and B&P advance agreements are often exceeded, the proper classification of consortium costs is particularly important, and depends on the nature and purpose of the work being conducted at the consortium.

c. MPE (FAR 31.205-25) does not cover basic and applied research effort related to new technology, materials, systems, processes, methods, equipment, tools, and techniques. These are all covered by the IR&D/B&P cost principle, FAR 31.205-18. Nor does MPE cover any development effort for manufacturing or production materials, systems, process, methods, equipment, tools and techniques, that are intended for sale. These costs are also covered by the IR&D/B&P cost principle. MPE covers only developing and deploying new or improved methods of producing a product or service when such new or improved technology is to be used in the contractor's own productive facilities.

7-2115.4 Classification of Costs and Audit Considerations

a. To properly classify consortium costs, the nature and purpose of the projects involved must be determined. Although FAR clearly delineates between IR&D and MPE costs, the technical nature of this work may make it difficult to distinguish between independent research and development and development effort not intended for sale. To assist the auditor in making these decisions, government technical specialist assistance should be sought. Procedures for identifying and obtaining technical specialist assistance are outlined in Appendix D.

b. The contractor should be able to provide documentation to support the nature and purpose of consortium projects. The contractor should also provide all legal documents (e.g., partnership agreements, shareholder agreements, certificates of incorporation, technology agreements) which pertain to the creation of the consortium. These documents often contain valuable information regarding the purpose of the consortium as well as information on other accounting issues such as income/loss distribution, payment schedules, and ownership of products or technology developed by the consortium.

c. When reviewing the nature and purpose of specific projects engaged in by a consortium, the following additional sources of information may prove helpful: (1) contractor interoffice memos discussing the project, (2) articles in company newsletters or journals, (3) slides/charts/minutes from company briefings or conferences, (4) papers or speeches to professional organizations or conferences, and (5) newspaper articles.

d. In addition to the distinction between MPE costs and IR&D costs, there are other important audit considerations pertaining to consortiums.

(1) Costs for consortiums may be charged to an account for trade and professional organizations. Included in these costs may be both basic membership fees and sponsorship fees for specialized research and development programs. The classification and allowability of these sponsorship fees will depend upon the nature and purpose of the research programs and the company's intended use of the resulting technology.

(2) An important consideration is the accounting treatment given any income/loss of the consortium. Usually, the consortium agreement provides for distribution of net income/loss to the individual member companies. The applicable portion of any income relating to allowable cost should be credited to the government in accordance with FAR 31.201-5.

(3) There may be significant related party transactions between the consortium and its members. A consortium may hire one or more member companies to provide a variety of services. For example, a member company may provide a consortium with executive search services or legal support. The applicable portion of any payment relating to an allowable cost should be credited to the government in accordance with FAR 31.201-5.

(4) The employees of a member company may be temporarily assigned to the consortium. The consortium may reimburse the company for employees' salary and relocation expenses. The accounting for the employee's salary and any reimbursement a member company receives for the loan of its employee should be determined.

7-2116 Lobbying Costs

Lobbying costs represent amounts incurred to influence the outcome of elections, referendums, legislation, and other governmental actions at all levels of government.

7-2116.1 Lobbying Cost Principle

a. FAR 31.205-22 disallows most costs incurred to influence elections, public votes on issues, political parties, and legislation. It also disallows costs incurred to induce or tend to induce, either directly or indirectly, executive branch employees to give consideration or to act regarding a government contract on any basis other than the merits of the matter. FAR 31.205-22(b) states that the following lobbying costs are allowable:

(1) Costs that result from requests by a legislative body for certain types of information.

(2) Costs for influencing state or local legislation in order to directly reduce contract cost or to avoid material impairment of the contractor's authority to perform the contract.

(3) Costs for performing any activity specifically authorized by statute to be undertaken with contract funds.

b. FAR 31.205-22 sets forth requirements for supporting and claiming allowable costs and for disclosing unallowable costs that are not claimed. Unallowable lobbying costs must be separately and specifically disclosed in the submission as voluntary deletions from the contractor's final costs for the period. Lobbying costs may not be removed from the submission as part of an undifferentiated total which includes other types of costs. Likewise, a contractor may not simply exclude the costs without identifying that the costs were incurred and removed. Prior to August 19, 1996, FAR 31.205-22(f) exempted contractors from certain timekeeping requirements when employees spent less than 25 percent of their total time engaged in lobbying activities. This exemption was deleted effective August 19, 1996 because it implied a conflict with other existing record keeping requirements in the FAR and CAS. Contractors were, and still are, required to maintain records adequate to support allowable lobbying costs claimed and to segregate unallowable lobbying costs not claimed, in accordance with the certification requirements (see 6-706).

c. DFARS 231.205-22(a), 231.303(3), 231.603 and 231.703, effective September 8, 1997, implement Section 7202 of the Federal Acquisition Streamlining Act of 1994 pertaining to legislative lobbying costs. The DFARS provisions disallow costs incurred by DoD contractors for preparing any material, report, list, or analysis concerning the actual or projected economic or employment impact in a particular state or congressional district of an acquisition program for which all research, development, testing and evaluation has not been completed.

7-2116.2 Lobbying in Connection with Federal Contracts and Other Federal Actions - Byrd Amendment

a. FAR Subpart 3.8 implements 31 U.S.C. 1352, entitled "Limitation on Use of Appropriated Funds to Influence Certain Federal Contracting and Financial Transactions." This legislation, which was signed into law on October 23, 1989, is commonly referred to as the Byrd Amendment. The legislation has been implemented by contract clause, as opposed to a change in the FAR cost principles. Effective December 23, 1989, solicitations exceeding $100,000 are required to include the clauses at FAR 52.203-11 (Certification and Disclosure Regarding Payments to Influence Certain Federal Transactions). Effective December 23, 1989, both solicitations and contracts are required to include the clause at FAR 52.203-12 (Limitation on Payments to Influence Certain Federal Transactions).

b. FAR clause 52.203-12 makes the cost of certain lobbying activity unallowable. The activity covered is influencing or attempting to influence an officer or employee of an agency, a Member of Congress, an officer or employee of Congress, or an employee of a Member of Congress in connection with any covered Federal action. A covered Federal action

is defined as (1) the awarding of any Federal contract, (2) the making of any Federal grant, (3) the making of any Federal loan, (4) the entering into of any cooperative agreement, or (5) the modification of any Federal contract, grant, loan, or cooperative agreement.

c. The Act does not apply to the following activities:

(1) Providing information specifically requested by a Member of Congress, an employee of Congress, an employee of a Member of Congress, or an officer or employee of a Federal agency.

(2) Agency and legislative liaison by a contractor's regularly employed employee, provided the activity is prior to or not directly related to a specific solicitation.

(3) Selling activities by independent sales representatives, provided such activities are prior to formal solicitation and limited to the merits of the matter.

(4) Professional or technical services rendered directly in the preparation, submission, or negotiation of a bid or proposal, provided such services are limited to providing advice and analysis which directly applies a professional or technical discipline and are further limited to the merits of the matter.

7-2116.3 Lobbying Disclosure Act of 1995

a. The Lobbying Disclosure Act (LDA) of 1995, which became effective January 1, 1996, significantly expanded the registration and reporting requirements for those who engage in lobbying activities. An organization must register (Form LD-1) and file semiannual reports (Form LD-2) with the Secretary of the Senate and the Clerk of the House if the organization has at least one employee who meets the statutory definition of lobbyist, and (1) the organization's total lobbying expenses exceed $20,000 (in the case of in-house lobbyists) or (2) the firm's total income from lobbying activities for a particular client exceeds $5,000 (in the case of a lobbying firm, including a self-employed lobbyist) during a semiannual reporting period. The Act defines lobbyist as a person who spends 20 percent or more of his or her time on lobbying activities that include more than one lobbying contact. A lobbying contact encompasses virtually any oral or written communication (including an electronic communication) to certain executive and legislative branch officials. The Act requires the dollar thresholds to be adjusted on January 1, 1997 and at 4-year intervals thereafter to reflect changes in the Consumer Price Index. For the January 1, 1997 adjustment, the $5,000 threshold for lobbying firms remains unchanged, and the threshold applicable to organizations employing in-house lobbyists is adjusted to $20,500.

b. Lobbying firms are required to file a separate registration and semiannual report for each client, while organizations employing in-house lobbyists file a combined registration and semiannual report covering their entire in-house lobbying activities. Semiannual reporting requires registrants to disclose specific lobbying issues, the name of each employee who acted as a lobbyist, and the organization's total lobbying expenses for in-house lobbyists or the firm's total income for a particular client for a lobbying firm.

c. Auditors should determine whether the contractor is a registrant under the Act and obtain copies of the semiannual reports filed by the contractor in planning and performing audits of lobbying costs and audits of a contractor's Washington Office costs. Unallowable lobbying expenses identified and excluded from the contractor's overhead settlement proposals should be reconciled with the total expenses reported on semiannual reports. If any significant differences are found, the auditor should request an explanation from the contractor. The list of employees and specific lobbying issues disclosed in semiannual reports should also be considered in planning and performing audits of labor costs. However, it should be noted that this list may not include all employees participating in lobbying efforts because of the "20 percent rule" and minimum one lobbying contact requirement.

7-2117 Military Operations -- War Hazard, Reserve Supplements, and Desert Storm

7-2117.1 War Hazard Pay

a. Contractors will sometimes offer hazardous duty pay as an incentive to employees performing work under unusually dangerous situations. These incentives vary among contractors and may reflect differences in individual circumstances. Such incentives are to be evaluated for reasonableness on a case-by-case basis. Each contractor should support the reasonableness of the incentives by presenting evidence that may be relevant to the particular circumstances. War hazard differentials may well be justified in order to ensure that critical functions are maintained in support of our troops.

b. The amount of war hazard pay necessary in a given situation will depend on many factors, such as:

(1) Country and city where assigned,

(2) Distance of work site from actual battlelines and surrounding areas of imminent danger,

(3) War hazard differentials being offered by other defense contractors in the same location,

(4) Employee response to any lower war hazard differential pay offers made by the contractor,

(5) Availability of alternate workers at appropriate skill level, and

(6) Other compensation offered, such as bonuses and insurance coverage.

c. Auditors should review the reasonableness of the process by which the war hazard differentials are set without any preconceived idea of what percentage or dollar amount is to be accepted as reasonable. Whatever policy the contractor sets should be consistent to ensure that the contractor is not paying the war hazard differential only where it can be reimbursed on government contracts (e.g., flexibly priced contracts). Contractors should also be encouraged to set forth their policy in writing to the cognizant ACO and enter into an advance agreement to avoid misunderstandings.

7-2117.2 Supplemental Reservist Payments

a. Many companies choose to continue certain fringe benefits, such as health insurance, for employees who have been called to military duty. In addition, many companies pay these individuals the difference between their civilian and military salaries in an effort to help mitigate the hardships that those called to active military duty will experience. In accordance with an October 5, 2001 memorandum issued by the Under Secretary of Defense for Acquisition, Technology and Logistics, these types of supplemental benefits for extended military leave are to be considered allowable costs pursuant to FAR 31.205-6, Compensation for personal services.

b. Allowable amounts are limited to the lesser of (a) the contractor's extended military leave benefits plus active duty pay, or (b) the total compensation of an employee at the time of entry into active military duty. For purposes of computing this limitation, active duty pay includes basic pay, all specialty pay, and all allowances, except for subsistence, travel, and uniform allowances.

7-2117.3 Operation Desert Storm Homecoming Celebration Expenses

a. In accordance with a June 3, 1991 memorandum issued by the Director of Defense Procurement, Operation Desert Storm homecoming activities are considered to be a national celebration. If costs are incurred for participating in honoring the Desert Storm troops and celebrating the operation's success, this section applies.

b. As a general rule, the costs of participation are allowable because participation costs are considered as being incurred in different circumstances than public relations or advertising costs. However, costs which would otherwise be specifically unallowable are still unallowable (see 7-2117.3e.).

c. Allowable contractor participation costs include labor, material, and other direct costs of the celebration. Employee time to participate in the activities could include time to march in a parade or fabri-

cate a parade float. Contractors should be allowed material and other direct costs of floats, displays, or exhibits appropriate to the celebration activity. Generally, the allowability of such costs is linked to employee morale and will normally involve celebrations in the locality of the contractor facility. While there is no specific limit on the number or location of celebration activities that would be allowable for a contractor, there should be a clear linkage to employee morale.

d. Employee absence from the workplace to attend the celebrations is allowable if the associated costs are reasonable. Most celebration activities were scheduled for holidays or weekends when there would be little or no contractor costs for employee attendance. When activities were scheduled for normal work time, reasonable personal absence costs are allowable.

e. Certain costs remain unallowable even if associated with such celebrations. Any advertisement to the public of any nature is subject to FAR 31.205-1, although the contractor is allowed to include its name and logo on a banner, sign, and/or float used in the celebration activity. Costs of souvenirs, models, imprinted clothing, buttons, and other mementos distributed during the celebration are unallowable under FAR 31.205-1(f)(6). Contributions to local governments or other third parties to pay for celebration activities are unallowable contributions under FAR 31.205-8.

7-2118 Costs Related to Legal and Other Proceedings

a. The specific conditions for allowability of costs associated with legal and other proceedings are addressed in FAR 31.205-47. The cost principle applies to the total costs incurred for the subject purpose including all costs directly associated with legal and other proceedings.

b. “Costs” under FAR 31.205-47 include, but are not limited to, administrative and clerical expenses; the costs of legal services, whether performed by in-house or private counsel; the costs of the services of accountants, consultants, or others retained by the contractor to assist in preparation or presentation; costs of employees, officers, and directors; and any other similar costs incurred before, during, and after commencement of a proceeding (FAR 31.205-47(a)).

c. Cost of outside services should be supported by invoices or billings which itemize such items as amounts applicable to retainer agreements, fees for services not covered by a retainer, expenditures for investigative and other services, and travel and miscellaneous expenses (FAR 31.205-33(f)).

d. In-house costs include salaries and related fringe benefits as well as the costs of secretarial and other support services, space, utilities, and library services. If a contractor maintains a legal capability in-house, the use of outside counsel should be limited to matters beyond the competence or workload capacity of the contractor's own legal department.

e. In addition to FAR 31.205-47 which addresses specific proceedings and FAR 31.205-33 which addresses outside consultant costs (including outside legal costs), the costs of legal proceedings must be reasonable both in nature and amount to be allowable in accordance with FAR 31.201-3.

7-2118.1 General Considerations on Legal Services

a. Outside legal services and outside support for legal services are generally considered as specific kinds of professional or consultant services subject to the provisions of FAR 31.205-33, as discussed in 7-2105.

b. Costs of in-house legal services ordinarily cover a variety of legal activities related to the overall administration and management of the contractor's business. They are usually accounted for without further identification as part of in-house general and administrative expenses. Audit determinations on allowability will generally be made in consideration of the overall amounts involved. The auditor should not undertake, or request the contractor to undertake, a detailed analysis to classify costs by function or specific activity unless an overall review indicates that the amount is obviously excessive or that a significant portion of the effort of legal personnel was devoted to activities designated in FAR

31.205 as unallowable or not allocable to government business (see 7-2118.9).

7-2118.2 Definitions

a. "Cost," as used in FAR 31.205-47, includes all costs which would not have been incurred but for the proceeding. This includes costs incurred before, during, and after the proceeding. The concept of "before the proceeding" should be interpreted to cover the following: (1) when a contractor anticipates and begins to prepare for a proceeding before it has been officially notified that a governmental unit has initiated a proceeding and (2) when the contractor is conducting its own investigation or inquiry preparatory to initiating a proceeding.

b. A proceeding includes any investigation, administrative process, inquiry, hearing, or trial conducted by a local, state, Federal, or foreign governmental unit or brought by a third party in the name of the United States under the False Claims Act, and appeals from such proceedings.

c. A penalty does not include a payment to make a unit of government whole for damages or the interest accrued on the damages. A penalty is in the nature of a punitive award or fine.

d. A “qui tam” proceeding is a proceeding brought to court by a private citizen (third party) on behalf of the government. The False Claims Act, 31 U.S.C. 3730, specifically allows private citizens to bring suit to recover and restore funds to the government which were obtained by fraudulent contractor practices. A legal determination has been made that a “qui tam” proceeding (whether or not the government elects to intervene) is a “proceeding brought by the Federal government” as that term is used in FAR 31.205-47(b).

7-2118.3 Allowability of Costs

Costs of some proceedings are allowable subject to a ceiling if the contractor prevails in an action, some are always unallowable, and others are completely allowable if the contractor prevails in an action. Costs associated with routine proceedings, not specifically addressed in the FAR cost principle, are generally allowable if reasonable in nature and amount.

7-2118.4 Allowable Cost Ceiling for Certain Proceedings

a. If the outcome of a proceeding described in FAR 31.205-47(b) determines costs to be allowable, the maximum amount allowable is still limited to the extent that the costs:

(1) are reasonable considering the requirements and underlying cause of the proceeding;

(2) have not been otherwise recovered from any source; and

(3) do not exceed 80 percent of the total otherwise allowable cost. A percentage less than 80 percent could be appropriate considering the circumstances of the case and the legal work involved.

b. The 80 percent limit also applies to the costs related to proceedings settled by consent or compromise under the conditions described in 7-2118.5a.(5).

c. The unallowable portion (amount over the ceiling) is considered to be a copayment to encourage contractors to incur proceedings costs responsibly even in a winning case.

7-2118.5 Proceedings Allowable Subject to a Ceiling if the Contractor Prevails

a. Costs of the following proceedings commenced by a governmental unit (Federal, state, local, or foreign) or by a third party on behalf of the United States for violation of, or a failure to comply with, law or regulation are unallowable if the proceedings result in the indicated outcomes; otherwise, costs are allowable subject to the ceiling (FAR 31.205-47(b)):

(1) In a criminal proceeding, a conviction.

(2) In a civil or administrative proceeding (including a qui tam proceeding) involving an allegation of fraud or similar misconduct, a finding of liability.

(3) In a civil or administrative proceeding not involving an allegation of fraud or similar misconduct, an assessment of a monetary penalty.

(4) In a proceeding held by an appropriate official of an executive agency for debarment or suspension of the contractor; rescission or voiding of a contract; or termination of a contract for default because

of violation of or noncompliance with a law or regulation, a final decision unfavorable to the contractor.

(5) In any proceeding shown in (1) through (4) which could have led to the associated outcome, settlement by consent or compromise. Except for qui tam suits in which the United States did not intervene, if the contractor, its agent, or its employees were at risk of one of the stated outcomes of the above proceedings and the proceeding is settled by consent or compromise, the settlement is treated as a loss for purposes of allowability of the costs. In the event of a settlement of a qui tam suit in which the government did not intervene, the costs may be considered allowable if the contracting officer, in consultation with his or her legal advisor, determines that there was very little likelihood that the third party would have been successful on the merits.

b. FAR 31.205-47(b)(5) also makes unallowable any costs of a proceeding involving the same underlying alleged contractor misconduct addressed in another proceeding whose outcome determined the costs to be unallowable (see a. above). If a contractor loses, settles, or compromises one proceeding associated with alleged contractor misconduct, all litigation costs for all other proceedings related to the same misconduct are also unallowable.

c. Unallowability of costs under FAR 31.205-47(b) or (e) for a non-Federal government proceeding may be waived when an appropriate cognizant U.S. government official determines that the costs were incurred either (FAR 31.205-47(d)):

(1) as a direct result of a specific term or condition of a Federal contract; or

(2) as a result of compliance with specific written direction of the cognizant contracting officer.

7-2118.6 Proceedings Which Are Always Unallowable

a. Defense or prosecution of claims or appeals against the Federal government (FAR 31.205-47(f)(1)). This includes the cost of preparing and presenting an appeal before a board of contract appeals (see Lear Siegler, Inc. (1979) ASBCA No. 20040, 79-1).

b. Organization, reorganization, mergers, or acquisitions, or resistance to merger or acquisition (FAR 31.205-47(f)(2) and FAR 31.205-27).

c. Defense of antitrust suits (FAR 31.205-47(f)(3)).

d. Defense or prosecution of lawsuits or appeals between contractors arising from such agreements as teaming arrangement, dual sourcing, co-production, or similar programs. However, these costs are allowable if incurred as a result of compliance with specific terms and conditions of the contract or written instructions or approval from the contracting officer (FAR 31.205-47(f)(5)).

e. Patent infringement proceedings if not required by the contract. This does not include general counseling services such as advice on patent laws and regulations. (FAR 31.205-30, FAR 31.205-47(f)(6)). Also see 7-702.

7-2118.7 Proceedings Allowable Without Cost Ceiling if the Contractor Prevails

Costs of the following proceedings are unallowable with the stated outcome; otherwise, the costs are allowable without the 80 percent ceiling:

a. Defense of suits brought by employees or ex-employees of the contractor under Section 2 of the Major Fraud Act of 1988 when the contractor was found liable or the case was settled (FAR 31.205-47(f)(4)).

b. Representation of, or assistance to, individuals, groups, or legal entities that the contractor is not "legally bound" to provide, arising from an action where the party being represented or assisted was convicted of a violation of law or regulation or was found liable (FAR 31.205-47(f)(7)).

7-2118.8 Proceedings Related to Bid Protests

a. Costs of bid protest proceedings may be incurred by both the protester and the contractor. Bid protest costs and costs of defending against protests are expressly unallowable under FAR 31.205-47(f)(8) for contracts awarded on or after October 7, 1996. However, costs of de-

fending against a protest, when incurred pursuant to a written request from the contracting officer, are allowable, if reasonable.

b. In the past, the ASBCA ruled that bid protest costs were allowable because bid protests did not fall within the definition of a contract disputes claim referenced in FAR 31.205-47(f). (See Bos'n Towing and Salvage Company, ASBCA 41357). Therefore, the allowability of bid protest costs for contracts awarded prior to October 7, 1996 was based on reasonableness criteria provided in FAR 31.201-3. A contractor who received the contract award being protested may have incurred legal expenses in defending against a bid protest as an "interested party." In one situation, the costs of defending against a bid protest were charged directly to the contract since they met the FAR 31.202 definition of a direct cost (Jana, ASBCA 32447). However, the Board disallowed direct bid protest costs which were incurred before the contract award date because they did not meet the precontract costs requirement that the costs must be necessary to comply with the proposed contract delivery schedule (FAR 31.205-32). Therefore, bid protest costs incurred before the contract award date are not allowable For a successful protest, the protester may receive, as part of the proceeding, the reasonable costs of the bid protest. Auditors should assure any funds awarded are credited to the account where the protest costs had been charged.

7-2118.9 Segregation and Withholding of Proceedings' Costs

a. FAR 31.205-47(g) requires that costs of a proceeding whose outcome determines cost allowability be segregated by the contractor and payment be withheld by the contracting officer until the outcome is determined. Thus costs described in 7-2118.5 and 7-2118.7 should be segregated as incurred and not billed to the government until the outcome is determined.

b. The contracting officer may enter into an advance agreement to make conditional payments to the contractor for such potentially unallowable costs if the contractor agrees to repay the government with interest if the ultimate outcome of the proceeding makes the cost unallowable. In advising the contracting officer about such agreements, it should be noted that most such proceedings' costs are subject to the 80 percent ceiling even when the contractor wins. Therefore, the 20 percent over-ceiling amounts are not billable even with an advance agreement.

c. Costs related to proceedings which are unallowable regardless of the outcome (7-2118.6) are required to be segregated and removed from government billings in accordance with CAS 405 and FAR 31.201-6.

d. Costs incurred using outside counsel or other outside resources should be easily identified and segregated. For costs incurred in-house, the contractor will need to have internal controls in place to identify costs as they are being incurred pursuant to the proceedings described in 7-2118.5, 7-2118.6, and 7-2118.7.

e. The contractor is not required to anticipate whether a routine inquiry or action will result in a potentially unallowable cost proceeding. Cost identification to (or incurrence for) a particular proceeding cannot begin before the contractor has notice of the proceeding, unless the contractor anticipates such a proceeding and on its own begins to incur costs. Anticipatory costs incurred by a contractor are considered to be related to a proceeding even if the unit of government has not notified the contractor of the proceeding, or even if the contractor stops its preparations for a proceeding without notifying the government. A specific notifying event or a contractor anticipatory decision, accompanied by incurrence of significant costs, triggers the segregation and withholding.

7-2118.10 Defense of Stockholder Suits

a. Auditors should question costs incurred to defend against stockholder suits that are related to contractor wrongdoing. The costs should be questioned as being directly related to an unreasonable action (the wrongdoing).

b. A stockholder suit may be brought by stockholders to protect their own interests or on behalf of the corporation to protect

the interests of all the stockholders of the corporation. Not all stockholder suits are related to wrongdoing.

c. The defense of a stockholder suit is unreasonable in its nature if the suit is directly related to wrongdoing against the stockholders or is based on other previously established wrongdoing which the stockholders believe caused loss to the corporation. In either case, the stockholder suit and the associated defense costs would not be incurred but for an unreasonable act by the corporation or its agents. While it may be reasonable (or even required by law) for the corporation to defend itself or its agents against such suits, it would not have been placed in the position of defending itself if the wrongdoing had not taken place.

d. Wrongdoing includes actions such as those described in FAR 31.205-47(b) & (f)(4), intentional harm to other persons, and instances where there has been a reckless disregard for the harmful consequences of an action.

e. A stockholder allegation of wrongdoing, in itself, is not sufficient evidence to establish unallowability of the costs associated with a stockholder suit proceeding. Wrongdoing is demonstrated when a court or other official body has determined that wrongdoing occurred. Wrongdoing may also be established when a contractor reaches a settlement without a court or board finding of wrongdoing if the facts underlying the settlement indicate that the contractor or its agents engaged in wrongdoing.

f. When questioning costs incurred to defend against stockholder suits, the auditor's working papers should document the basis for the auditor's determination that the wrongdoing occurred and that the wrongdoing was the basis for the stockholder suit.

7-2118.11 Audit Considerations

a. The regulatory history for FAR 31.205-47 includes the following guiding principles which should be considered in applying the cost principle to specific cases:

(1) The government should not pay for wrongdoing, the defense of wrongdoing, or the results or consequences of wrongdoing by contractors.

(2) The government should not encourage litigation by contractors.

(3) Government contractors should not be put in a better position than contractors in the commercial area.

(4) The government should not discourage contractors from enforcing the government's rights and protecting the government's interests.

b. The auditor should review costs segregated by the contractor to determine that all known unallowable and potentially unallowable proceedings costs have been included.

c. Legal services cost billings and other documents related to unallowable proceedings should be carefully reviewed to identify other unallowable proceedings and professional service costs which should also be segregated. Any in-house support costs (particularly in the legal and accounting departments) incurred for unallowable types of proceedings should also be segregated.

d. The audit of internal controls should include an evaluation of the contractor's practices and policies for approval/payment of bills submitted by outside legal counsel. Adequate internal controls include:

- written policies/procedures regarding the reasonableness and allowability of costs submitted by outside legal counsel;
- an established policy regarding the types of information and provisions to be included in agreements with outside legal firms;
- a designated reviewer(s) of bills submitted by outside legal counsel; and
- a procedure to be followed when the reviewer believes the outside legal bills contain duplicate or excessive charges.

When the contractor's internal controls are inadequate, the auditor should follow the guidance contained in 5-100.

e. The audit of internal controls over legal costs should also determine if the contractor has adequately trained its employees to recognize proceedings subject to the cost principle. Particular attention should be given to non-contract proceedings which might not be obvious and could be handled

by attorneys not normally involved in Federal contract law. For example, if a dispute over a municipal ordinance violation or an IRS inquiry was subject to a penalty, the associated costs would be subject to the provisions of FAR 31.205-47(b).

f. In-house legal staff handles routine inquiries from government agencies. Replies to such inquiries are not considered to be related to proceedings triggering segregation and withholding unless the contractor has specific knowledge that the inquiry is pursuant to a proceeding type listed in the cost principle or the contractor for its own reasons chooses to treat the inquiry as preparatory to an anticipated proceeding. A contractor might make such a choice because of other knowledge it has of the subject of the inquiry or any other reason to believe that it may be at risk.

g. If the contractor's internal controls for its in-house legal services are adequate, segregation of insignificant in-house costs related to minor proceedings (five-minute telephone calls and routine reply letters) should not be required. Aggressive defense or prosecution of proceedings listed in the cost principle cannot be considered insignificant, i.e., pleading not guilty, or appearing in court to make arguments, extensive in-house investigation, or other support activities.

h. Contractor responses to or support of audits by DCAA are not proceedings subject to disallowance within the meaning of the cost principle.

(1) Although criminal and civil proceedings have sometimes started as the result of DCAA audits, there is no presumption of a proceeding subject to the cost principle until an agency with sufficient authority opens such a proceeding and the contractor is notified. If a contractor chooses to treat the audit as a covered proceeding or to begin preparations for an appeal before a final decision is made, then the contractor cost associated with such preparations for a proceeding would be subject to segregation. The level and nature of the contractor's response would determine its treatment.

(2) Questioning costs based on the level or nature of the contractor’s response would be a sensitive matter. Any action which discouraged a full response from the contractor at the earliest point in the audit or negotiation process would be counterproductive to the speedy resolution of issues. Nevertheless, if the contractor begins extensive or specific activities obviously aimed at appeal of a contracting officer's decision or any other listed proceeding before an official decision or proceeding, the costs must be identified and segregated for billing withholding.

i. Contractor response to the assessment of a penalty by the ACO for inclusion of unallowable costs in a certified final overhead cost submission pursuant to FAR 42.709 is a proceeding as described in 7-2118.5a(3). The penalty proceeding is separate from the indirect rate resolution process and proceedings. Contractors should segregate and withhold the legal and accounting costs associated with the penalty proceeding until the outcome is determined.

j. If the contractor is not segregating and withholding costs of proceedings as required by the cost principle, the auditor should attempt to persuade the contractor to comply. The ACO should be notified of such instances concerning progress payments and a DCAA Form 1 (Notice of Costs Suspended and/or Disapproved) should be prepared for disallowance or suspension of such costs included in public vouchers. The auditor should take care in the oversight of this cost area so as not to prematurely disclose the existence of a government proceeding to the contractor.

7-2119 Accounting for Lump-Sum Wages Resulting from Union Contracts

7-2119.1 General

This section provides audit guidance on the proper accounting for lump-sum wage payments resulting from union contracts. Union contracts may provide that union member employees receive a lump-sum payment in lieu of or in addition to an increase in their base wage rate. The specific terms of lump-sum payments may vary, but ordinarily the employee is not required to refund to the company any portion of the payment if the employee terminates em-

ployment prior to the end of the contract period.

7-2119.2 Future Benefit of Lump-Sum Payments

a. Neither the FAR, CAS, or Statements of Financial Accounting Standards (FAS) provide specific guidance on the accounting of lump-sum wages. The Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board (FASB) released Issue Summary (EITFIS) No. 88-23 dated December 1988, "Lump-Sum Payments Under Union Contracts" which provides specific guidance regarding the accounting for lump-sum payments. In the absence of specific guidance in the FAR, CAS, or FAS, the EITFIS which interprets GAAP is the appropriate accounting guidance to follow.

b. EITFIS 88-23 concludes that lump-sum payments are similar to an intangible asset in that the payments provided to the individuals in the current period will benefit future periods in the form of reduced payroll expense. In addition, the EITFIS 88-23 notes that Accounting Principles Board (APB) Opinion No. 12 requires that amounts estimated to be paid under deferred compensation contracts with employees be accrued in a systematic and rational manner over the period of active employment beginning at the time the union contract is entered into. Although the lump-sum payments are generally made at the beginning of each year, they should receive similar treatment so that the expense is recognized in a systematic and rational manner. EITFIS 88-23 concludes that since the current lump-sum payments clearly benefit future periods, the matching concept requires that they be deferred and amortized over the period benefited; e.g., the period covered by the union contract.

7-2119.3 Multiple Lump-Sum Payments

EITFIS 88-23 addresses a single lump-sum payment. What happens when the union contract requires multiple lump-sum payments to be made over the period of the union contract? Discussions with the FASB staff led to the conclusion that each payment should be amortized from the scheduled date of payment to the date of the next scheduled payment. For example, if the union contract requires three lump-sum payments to be made on October 1, 1990, 1991, and 1992, with the contract expiring on September 30, 1993, then the costs of the October 1, 1990 payment should be amortized from October 1, 1990 to September 30, 1991, the October 1, 1991 payment from October 1, 1991 to September 30, 1992, and the October 1, 1992 payment from October 1, 1992 to September 30, 1993.

7-2119.4 Effect of Delay in Union Contract Execution

a. A union contract may not be signed until some time after the previous contract has expired. Generally, the new contract will be retroactive, with an effective date coinciding with the expiration date of the prior contract. In such cases, the employees will usually receive a lump-sum payment on the date the contract is signed, although the period covered by the contract begins some time earlier. The matching principles discussed in the previous paragraphs should also apply here; i.e., the lump-sum payments should be amortized over the period of the union contract. The question is whether the amortization period begins at the time the contract is executed or at the time it is effective. The key to answering this question is determining the time at which the liability constructively exists.

b. Statement of Financial Accounting Concepts (SFAC) No. 6 defines liabilities as "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events." When employees continue to work after the old union contract expires in anticipation of a new contract, the act of continuing to work may constitute the past event referenced in the SFAC. In some circumstances, by continuing to work, the employees are showing that they anticipate receiving some future benefit. Under these circumstances, it would be difficult for the contractor to avoid making payments (a future transfer of assets) to these employees, either in the form of lump-sum payments, cost of living adjustments, or

other benefits. Finally, the probable future sacrifice of benefits would be the lump-sum payments, provided it can be reasonably forecasted that these payments will be included in the new union contract. Therefore, if it can be reasonably forecasted that the payments will be made, then the costs should be amortized over the union contract period beginning on the effective date of the contract. Conversely, if it can be shown that future payments are not probable (e.g., lump-sum payments are not included in the union labor package, lump-sum payments are in dispute, or the union negotiating position includes elimination of the lump-sum payments), then a liability does not exist until the union contract is signed. Thus, if these conditions have been met, the lump-sum payments should be amortized over the period covering the date of contract execution through the date of contract expiration (or the date of the next scheduled payment in the case of multiple payments). The key factor is to determine if there was a prior expectation that the lump-sum payments would be included in the new union contract.

7-2119.5 Accounting Change

For those contractors whose accounting practice is to accrue the payments in advance or to expense the lump-sum when paid, a change from the current method to amortization over the union contract period constitutes a change in the method of assigning costs to cost accounting periods. The contractor is subject to the requirements of FAR 52.230-6, Administration of Cost Accounting Standards, including the preparation of a cost impact proposal for those contracts that contain this clause.

7-2120 Environmental Costs

7-2120.1 Summary

Environmental costs are normal costs of doing business and are generally allowable costs if reasonable and allocable. Some environmental costs must be capitalized when the incurrence of such costs improves the property beyond its acquisition condition or under certain circumstances when the costs are part of the preparation of the property for sale. If environmental clean-up efforts resulted from contamination caused by contractor wrongdoing, the clean-up costs are not allowable. Environmental costs may be subject to future recoveries from insurance companies and other sources, which may not be reasonably predictable at the time the environmental clean-up costs are paid. Some of the sources of recovery may be unknown when the contractor pays for environmental clean-up costs. As such, clean-up costs claimed or forecasted are usually not reflective of the contractor's ultimate liability for the costs. Therefore, the forecasted costs should be treated as contingent costs subject to FAR 31.205-7, Contingencies. Also, any otherwise allowable incurred environmental clean-up costs should be accepted contingent upon the government sharing in any future recoveries from insurance policies or other sources. Advance agreements should be recommended to protect the government's interests in any future recoveries of clean-up costs reimbursed by the government.

7-2120.2 Types of Environmental Cost

Environmental costs include costs to prevent environmental contamination, costs to clean up prior contamination, and costs directly associated with the first two categories including legal costs. Costs associated with fault-based liabilities to third parties are not environmental costs (see 7-2120.12).

7-2120.3 Cost Principles Applicable to Environmental Cost

The costs incurred to clean up environmental contamination are considered to be normal business expenses. The primary cost principles applicable to environmental costs are FAR Subsections: 31.201-2, Allowability; 31.201-3, Reasonableness; and 31.201-4, Allocability. Other cost principles applicable in specific circumstances include FAR Subsections: 31.201-5, Credits; 31.205-3, Bad debts; 31.205-7, Contingencies; 31.205-15, Fines, penalties, and mischarging costs; and 31.205-47, Costs related to legal and other proceedings.

7-2120.4 Normal Business Expense

Normal business expenses are those expenses that an ordinary, reasonable, prudent businessperson would incur in the course of conducting a competitive for-profit enterprise. In the context of environmental costs, normal business expenses are measured by the actual costs incurred in the period. Not all normal business expenses are allowable for government contract costing purposes. To be allowable, costs must also be reasonable in amount, allocable to government contracts, and not be specifically unallowable under government cost principle provisions.

7-2120.5 Reasonableness of Environmental Cost

a. The key concept for reasonableness of environmental costs (both preventive and remedial) is that the methods employed and the magnitude of the costs incurred must be consistent with the actions expected of an ordinary, reasonable, prudent businessperson performing non-government contracts in a competitive marketplace. A government contractor should take measures to prevent or reduce contamination which a prudent businessperson would pursue to reduce its environmental costs.

b. Determination of reasonableness of clean-up costs also requires an examination of the circumstances of the contaminating events. Contractors should not be reimbursed for increased costs incurred in the clean-up of contamination which they should have avoided. In order to be allowable, contamination must have occurred despite due care to avoid the contamination, and despite the contractor's compliance with the law. Increased costs due to contractor delay in taking action after discovery of the contamination are not allowable. For forward pricing purposes, the costs should be net of reasonably available recoveries from insurance which would offset the clean-up costs.

7-2120.6 Allocability of Environmental Cost

Costs incurred to prevent environmental contamination will generally be allocated as an indirect expense using a causal or beneficial base. Costs to clean up environmental contamination caused in prior years will generally be period costs allocated through a company's G&A expense pool. Clean-up costs incurred at a home-office, group-office, or other corporate-office level should be allocated to the segment(s) associated with the contamination for inclusion as part of the segment's G&A cost. Clean-up costs incurred by a segment should be allocated through its G&A expense pool if no other segments were associated with the contamination. If other segments participated in the contamination, a fair share of the clean-up costs should be allocated to the other segments for inclusion in their G&A expense pool. This is in accordance with CAS 403 and 410 for CAS-covered contractors.

7-2120.7 Environmental Cost Related to Previous Sites and Closed Segments

a. If costs arise from a site the contractor segment previously occupied, the costs for clean-up would usually be allocated to the segment's site where the work was transferred. However, if the segment is closed with none of its former work remaining within the company, the cost would generally not be directly allocable to other segments of the business. There are many possible variations for the cost accounting treatment of environmental costs for a closed segment, depending on the facts of the particular situation. Information auditors should consider includes:

(1) Are any aspects of the closed segment's business being continued by the remaining segments?

(2) Is the site still owned by the contractor? If it is, what is its current use?

(3) If the site is not currently owned by the contractor, what were the terms of the sale in relation to environmental costs? The contractor may have retained environmental clean-up liability in exchange for a higher sale price or the buyer may have accepted full liability in exchange for a lower purchase price.

b. Each closed segment case must be reviewed based on its own facts to deter-

mine if the costs incurred for the closed segment should be directly allocated to other segments, be allocated as residual home office costs, or be treated as an adjustment of costs associated with the closing of the segment.

7-2120.8 Capitalization of Environmental Cost

a. Generally Accepted Accounting Principles as expressed in the Emerging Issues Task Force (EITF) Issue No. 90-8 indicate that environmental costs would normally be expensed in the period incurred unless the costs constitute a betterment or an improvement, or were for fixing up property held for sale. Betterments and improvements which exceed the contractor's capitalization threshold must be capitalized. Costs of fixing up a property for sale are generally considered to be part of the sales transaction, if realizable from the sale.

b. It would be unreasonable for the government to accept as current period costs expenditures which increase the value of contractor assets; accordingly, these costs should be capitalized for government contract costing purposes.

c. The EITF discusses the following situations where capitalization of the expenditures may be appropriate:

(1) Cost incurred to clean-up a site. These costs should be capitalized if the clean-up effort improves the property beyond the original condition of the property at acquisition. The costs incurred to restore a property to its acquisition condition are generally expensed unless they extend the property's useful life.

(2) Costs incurred to fix up property held for sale. These costs are to be capitalized, if they are realizable from the sale. A contractor may be required to incur contamination clean-up costs far in excess of any amount reasonably realizable upon sale. In the case of costs in excess of realizable costs, the excess amounts are expensed or capitalized depending on whether they improved the property beyond the property's condition at acquisition.

(3) Costs incurred to prevent future contamination. These costs would have an economic value in more than one period and should be amortized over their useful life. Capital assets purchased or constructed to prevent future contamination must be capitalized consistent with CAS 404 and GAAP.

d. Examples of capitalization of environmental costs:

(1) A contractor acquires property which was contaminated by a previous owner. Clean-up costs are capitalized as an improvement. Costs of ground and water clean-ups are increases to the book value of the land.

(2) A contractor cleans up contamination from its own operations since acquiring the property. If the property is being held for continuing use, the costs are expensed as period costs.

(3) A contractor incurs $80 million to clean up contamination it caused at a site which has a book value of $100 million and which is being held for sale at a price of $500 million. The $80 million is realizable from the sale and therefore, should be capitalized. If the sales price were $100 million instead, none of the $80 million would be realizable and it should be expensed in the period.

(4) The clean-up in example (3) is related to contamination existing at acquisition. In this situation, the $80 million would be capitalized even for the sale at a price of $100 million and would produce an $80 million loss on the sale. In effect, this would recognize that the contractor overpaid for the land at the time of acquisition.

7-2120.9 Potentially Responsible Party (PRP) for Environmental Clean-Up

a. The environmental laws usually require each Potentially Responsible Party (PRP) for contamination at a site to be individually liable for the complete clean-up of the site. The allowable environmental cost should only include the contractor's share of the clean-up costs based on the actual percentage of the contamination attributable to the contractor.

b. Contractors with the ability to pay will be required to fund clean-up efforts for sites where they are named as PRPs. If the government accepted contractor costs

on an ability to make payment basis, a government contractor could end up billing a disproportionate share of a site's clean-up costs to government contracts instead of recovering the excess payments from other PRPs.

7-2120.10 Environmental Bad Debts of Other PRPs

a. When a contractor pays for more than its share of the site clean-up, the contractor receives a right of contribution (or subrogation) against the other PRPs who did not make an appropriate contribution to the clean-up effort. If a contractor pays out more than its share of clean-up costs, it is up to that contractor to exercise its contribution rights to collect the amount over its share from the other PRPs who did not pay their share.

b. If a contractor cannot collect contribution or subrogation claims from other PRPs, the uncollected amounts are, in their essential nature, bad debts. Bad debts and associated collection costs, including legal fees, are unallowable costs (FAR 31.205-3 and 31.204(c)). However, see c. below for the exception to this guidance.

c. The guidance under a. and b. above does not apply in situations when all of the following three conditions are met: (1) a contractor is legally required to pay another PRP's share of the clean-up costs, (2) that PRP is out of business, and (3) there is no successor company having assumed that PRP's liabilities. When these three conditions are met, the clean-up costs which are attributable to the other PRP's contamination should not be disallowed as bad debt type expenses since there is no one against whom the contractor can take recovery action.

7-2120.11 Insurance Recovery for Environmental Cost

a. The insurance industry does not currently consider environmental contamination an insurable risk (at a reasonable cost) in most circumstances. The major exception is a sudden accidental contamination, such as an oil tanker spill resulting from a collision. If such insurance is available and reasonably priced, its cost would be allowable.

b. Some courts have found that policies written before the insurance industry began to specifically exclude environmental coverage do afford coverage for environmental damages. Any insurance recoveries for a contamination clean-up will be applied as credits against any costs which were or would be otherwise allowable for that clean-up effort.

c. environmental contamination events now generating costs were insured, either under specific environmental impairment or comprehensive general liability coverages, before the insurance industry developed its current underwriting exclusions. It is the earlier insurance policies which are the source of the potential claims. Most insurance companies are contesting the claims and when payments are made, they are based on partial settlements or are made after lengthy legal battles. When a claim is possible and economically feasible, the contractor should pursue it.

d. The auditor should inquire about the existence of environment contamination policies and comprehensive general liability policies which do not contain environmental clean-up cost exclusions. The kind and amount of policies in effect from the time of the contamination to the current date are significant for the purposes of negotiating costs and prices for government contracts.

e. The contractor's support for proposed clean-up costs should include a description of any insurance claim the contractor may have which could reduce the ultimate liability. The amount and timing of these claims for contract costing is a potential subject for negotiation which should be addressed by the auditor and ACO (see 7-2120.15b.).

7-2120.12 Fault-Based Liabilities to Third Parties

a. Examples of liabilities to third parties include health impairment, property damage, or property devaluation for residents or property owners near a contaminated site. These third-party claims arise from legal theories of tort and trespass, and losses from such claims would be unreasonable in nature for payment on a

government contract. Such costs are not environmental costs.

b. In the absence of a specific court finding of tort or trespass by the contractor, the facts of each case should be carefully examined to determine if any contractor payments are nonetheless based on those or other fault-based legal theories.

7-2120.13 Environmental Wrongdoing

a. If environmental clean-up costs are the result of contractor violation of laws, regulations, orders or permits, or disregard of warnings for potential contamination, the clean-up costs including any associated costs, such as legal costs, would be unreasonable and thus unallowable.

b. Fines or penalties are expressly unallowable under FAR 31.205-15 and any costs of legal proceedings where a fine or penalty could be imposed are covered by FAR 31.205-47. However, the incurrence of clean-up costs to correct environmental contamination is not a penalty; it is a legal obligation.

c. Most environmental laws do not require the contractor to be guilty of a violation to enforce contractor payment for clean-up costs. Therefore, it is rare for government agencies to bring criminal, or even administrative, charges for contamination. Auditors should request the contractors to provide documents sufficient to allow a determination as to how the contamination occurred. The Environmental Protection Agency, in designating a company as a Potentially Responsible Party (PRP), will normally provide a written rationale as to how the company contributed to the contamination at a site.

d. For purposes of disallowing the costs, the government must show that the preponderance of the evidence supports the position that the contractor violated the law, regulation, order or permit, or the contractor disregarded warnings for potential contamination. That is, it must be more likely that the government's allegation of wrongdoing is correct than that it is not.

e. The contractor should not be denied recovery of clean-up costs, if it complied with the laws, regulations, and permits in effect at the time of the contamination.

7-2120.14 Contingent Nature of Environmental Cost

a. Ideally, the government wants to negotiate contract prices based on the net environmental costs after recovery of insurance claims and any amounts owed by later-discovered PRPs. At the time that environmental costs are being incurred, it may not be possible to reasonably estimate what the net costs will ultimately be. Even where it is settled that a contractor will be required to clean up a prior contamination, it is rare that projections of the costs necessary to complete the project can be made with a reasonable degree of certainty.

b. Because of the uncertainty of the cost projections and of future recoveries from the insurance companies, as well as the difficulty in identifying all the other PRPs, both forecasted and incurred environmental clean-up costs and related legal costs that are allowable should be accepted contingent upon the government participating in any insurance recoveries or the identification of other PRPs at a later date. See 7-2120.15.

7-2120.15 Advance Agreements for Environmental Cost

a. There are many areas of judgment involved in the determination of allowability for environmental costs. It is necessary for the auditor and the ACO to coordinate closely during the audit. Advance agreements should be considered to facilitate negotiations with the contractor.

b. Acceptance of the costs may require some form of agreement to protect the government's interest. Any agreement to accept costs for clean-ups or for the costs of pursuing insurance recoveries should also provide expressly for government participation in any insurance claim recoveries and any reductions resulting from later-discovered PRPs. Consideration should also be given to requiring contractor diligence in pursu-

ing insurance recoveries and identifying contamination attributable to other PRPs. Advance agreements should provide for recovery of expenses priced into fixed price contracts if those expenses are later reduced based on subsequent identification of additional PRPs or insurance coverage after the agreement on price.

7-2120.16 Environmental Clean-Up Trust Funds

a. Making payments for clean-up efforts through a trust fund is a device for the administrative and the financing convenience of the PRPs named at a given site. The allowability of costs on government contracts should be based on the contractor's allocable share of the actual clean-up obligations. Contractor payments into a fund before clean-up costs are incurred are not an expense to the contractor until actual costs have been incurred for the site clean-up work. The excess or early payments are prepaid expenses.

b. It is the contractor's responsibility to support its claimed costs as allowable contract costs. Before accepting the contributions made to a trust fund as contract costs, auditors should obtain and evaluate sufficient supporting data to determine the allowability and the actual payment of the claimed costs. When the claimed "trust fund" costs are significant, the contractor should be requested, as part of its cost support, to arrange for government audit access to the accounting records of the trust fund.

7-2121 Domestic and Foreign Taxes - Differential Allowances

Tax differential allowances represent employee compensation for additional Federal, state, local, or foreign income taxes resulting from domestic or foreign assignments.

7-2121.1 FAR Applicability

a. For contracts entered into prior to December 31, 1996, under FAR 31.205-6(e), differential tax allowances for foreign assignments are unallowable if calculated directly on the basis of an employee's specific increase in income taxes. A specific increase is evidenced by any calculation that considers the employee's specific income tax liability, regardless of whether the calculation is made before or after the employee's actual taxes are known.

b. For contracts entered into on or after December 31, 1996, differential tax allowances for foreign assignments are allowable under FAR 31.205-6(e), even if the differential tax allowance is calculated directly on the basis of an employee's specific increase in income tax.

c. FAR 31.205-6(e) disallows any differential tax allowances for domestic assignments.

7-2121.2 Allowable Foreign Tax Differential Allowances

a. A foreign tax differential complies with the FAR provision if it is a fixed payment to employees on foreign assignment, such as a $3,000 annual payment, or if it is computed based on a percentage, such as 15 percent of all other foreign differential pay allowances.

b. Separate foreign tax differentials based on marital status and/or number of dependents comply with the FAR provision. An example would be a payment of 15 percent of the total amount of differential pay for all married employees and 10 percent for all single employees. Another example would be a differential of $3,000 for all employees, with an additional $500 for each dependent.

7-2121.3 Unallowable Foreign Tax Differential Allowances - Contracts Entered Into Prior to December 31, 1996

a. Foreign tax differentials based on the specific tax liability of a specific employee do not comply with the FAR provision in effect prior to December 31, 1996. For example, assume an employee has an estimated (or actual) tax liability of $5,000. Further assume that it is estimated that the tax liability would have been $3,000 had the employee remained on domestic assignment. As a result, the employee receives a tax differential of

$2,000. This amount was computed based on the employee's specific tax liability and is therefore unallowable.

b. Foreign tax differentials based on the increase in the tax rate for a specific employee or employees do not comply with the FAR provision. For example, assume that there are three employees, each of whom is single with no dependents. However, because of differing investment income and/or itemized deductions, each employee has a different increase in his/her tax rate as a result of the foreign assignment. If the contractor computes the tax differential payments using 10 percent for Employee A, 12 percent for Employee B, and 14 percent for Employee C, the payments would be unallowable, since they are computed based on specific tax liabilities of specific employees.

7-2122 Mentor-Protege Program Costs

7-2122.1 General

a. The Mentor-Protege Program is a socioeconomic program to aid small, disadvantaged businesses. It teams a well-established DoD contractor with one of its small, disadvantaged subcontractors to provide the small business with training and guidance in the art of running a successful business. DoD contractors may participate in the program during the period from October 1, 1991 to September 30, 2005. The DFARS coverage is in Subpart 219.71 and in DFARS Appendix 1.

b. Mentor-Protege Program costs are generally costs for developmental assistance that are in excess of the costs the prime contractor would normally incur in the administration of its subcontracts with small businesses. The costs can be internal costs of the mentor firm incurred to provide assistance using its own personnel or costs paid to third-party assistance providers that qualify under DFARS I-107(f)(7).

7-2122.2 Cost Classification

a. Depending upon the circumstances, Mentor-Protege Program costs may be classified as either direct or indirect costs.

b. Mentor-Protege Program costs will be classified as direct contract costs when the mentor-protege arrangement is included as a separately priced line item of a contract or when DoD has awarded a separate contract solely for the mentor-protege arrangement.

c. Mentor-Protege Program costs will be classified as indirect costs if there is no specific contractual requirement provided. Such costs should be allocated using the method normally used by the contractor to allocate indirect subcontract administration expenses.

7-2122.3 Allowability of Costs

a. Normal subcontract administration costs are allowable in accordance with the prime contractor's disclosed or established practices. Costs incurred in excess of normal subcontract administration costs, for the purposes set forth in DFARS, are allowable if the costs are:

(1) incurred in accordance with a DoD-approved mentor-protege arrangement;

(2) incurred prior to October 1, 1996 (costs incurred from October 1, 1996 until September 30, 1999 are only eligible for the credits discussed in 7-2122.5);

(3) incurred by using mentor firm personnel to provide direct assistance to the protege firm or by the mentor firm paying an approved outside provider of assistance; and

(4) otherwise reasonable, allocable, and allowable.

b. Mentor firms are urged to reach advance agreements with ACOs on the allowability of costs under an approved Mentor-Protege Program arrangement.

7-2122.4 Impact on Subcontract Awards

The mentor firm may award subcontracts noncompetitively to the protege firm as part of an approved arrangement. The Office of Small and Disadvantaged Business Utilization, Office of the Under Secretary of Defense for Acquisition (OUSD(A)SADBU) is responsible for approving mentor-protege agreements. Also, special advance payment and progress payment methods are available to pay the protege subcontractor.

7-2122.5 Credits Against Small, Disadvantaged Business Subcontracting Goals

a. The Mentor-Protege Program provides another incentive to mentor firms for participation in the program. Besides reimbursement of costs as previously discussed, the program also provides for credits toward subcontracting goals. The cost of any developmental assistance which is not reimbursed to the mentor firm as a direct or indirect contract cost is administratively applied toward the attainment of the mentor firm's Small and Disadvantaged Business Subcontracting Goals negotiated pursuant to FAR Subpart 19.7. Such costs are credited toward the subcontracting goals at the following multiples of the costs incurred:

(1) Four times the total amount of developmental assistance costs defined in DFARS Appendix I-107(f)(7);

(2) Three times the total amount of developmental assistance costs defined in DFARS I-107(f)(1); and

(3) Two times the total amount of other developmental assistance costs.

b. When requested by the contracting officer, the auditor should verify that amounts claimed as subcontracting plan credits represent eligible costs and are properly classified for purposes of the credit calculations.

7-2123 Bonuses and Incentive Compensation

7-2123.1 General

a. Many companies have adopted various bonus and incentive compensation plans to compensate employees. Bonuses and incentive compensation can take many forms, including cash, stock options, stock appreciation rights, phantom stock plans, etc., or some combination thereof and may be paid in the current period or future period(s).

b. Under traditional stock bonus and incentive plans, a company grants options to purchase a fixed number of shares of stock of the corporation at a stated price during a specified period or grants rights to purchase shares of stock of the corporation at a stated price. Stock bonuses (e.g., stock options and stock appreciation rights) are normally granted for future services of employees.

c. Phantom stock plans differ from stock option plans in that no stock is transferred to the employee and no cash outlays are required. Contingent stock shares are attributed to the employee. The employee's account may be increased by the equivalent dividends issued and any appreciation in the market price of the stock over the price of the stock on the measurement date.

d. Some corporations have replaced or supplemented traditional stock bonus and incentive plans with more complex plans which are often based on variable factors that depend on future events. For example, a corporation may award a fixed number of shares at a fixed price per share based on a stated increase in the company's earnings per share.

7-2123.2 Allowability of Costs and Audit Considerations

a. Auditors should review the bonus and incentive compensation plans to obtain an understanding of the unique terms and conditions of each plan, e.g., corporation awards a variable number of shares of stock at the end of a fixed period based on a fixed percentage increase in stock value over a stated period of time.

b. Bonuses and incentive compensation are allowable as set forth in FAR 31.205-6(f), (i), and (k) provided that the basis of the award is adequately supported and the award is made:

- According to an agreement established between the contractor and the employee before the services are rendered, or
- In conformity with an established plan or policy consistently followed.

c. Allowable costs for stock bonuses (e.g., stock options and stock appreciation rights) are limited to the fair market value of the stock on the measurement date, the first date that the number of shares awarded is known. If the stock option or stock appreciation price is equal to or greater than the market price on the measurement date, then no costs are allowed for contracting purposes.

d. Compensation based on changes in the prices of corporate securities or cor-

porate security ownership (such as stock options, stock appreciation rights, phantom stock plans, and junior stock conversions) are expressly unallowable under FAR 31.205-6(i).

(1) Contracts awarded on or after September 24, 1996. FAR 31.205-6(i) was revised, effective September 24, 1996, to expressly disallow:

- Any compensation which is calculated, or valued, based on changes in the price of corporate securities;
- Any compensation represented by dividend payments or which is calculated based on dividend payments; and
- Payments to an employee in lieu of the employee receiving or exercising a right, option, or benefit which would have been unallowable under paragraph (i).

The September 24, 1996 revision to FAR 31.205-6(i) did not introduce any new policy (i.e., compensation based on changes in corporate securities is unallowable). Rather, the government decided to be clear regarding its long-standing position that compensation costs based on changes in the price of corporate securities are unallowable, regardless of the name given the plan (e.g. stock options, stock appreciation rights, etc.) as emphasized in the Federal Register preamble language to the September 24, 1996 revision to FAR 31.205-6(i). This point is further emphasized in the Cost Principle Committee's November 7, 1995 report to the DAR Council. The Committee explanation for the revisions to FAR 31.205-6(i) states:

> These revisions highlight the Government's long-standing position that compensation based on changes in securities prices is not compensation based on work actually performed and thus, is unallowable...Further, we believe that dividend payments are essentially a distribution of profits and likewise should not be reimbursed by the Government...Since new stock scenarios are constantly emerging relative to the payment of bonuses for stock price changes, rather than trying to cover each individually in the cost principle, we have streamlined this paragraph to include a list of general prohibitions.

(2) Contracts awarded prior to September 24, 1996. Contracts awarded prior to September 24, 1996 are subject to the prior provisions of FAR 31.205-6(i) which did not expressly disallow compensation costs based on changes in the prices of corporate securities or dividend payments.

(a) For audits of compensation costs based on changes in the prices of corporate securities, auditors should question such costs citing FAR 31.205-6(i) and FAR 31.204(c). While it could be argued that compensation based on changes in corporate securities is not specifically addressed in FAR 31.205-6, the lack of specific coverage in the FAR does not make the costs allowable or unallowable. As stipulated by FAR 31.204(c), it is necessary to determine if the treatment of any similar or related items to the cost in question is included in FAR 31.205. It is DCAA's position that compensation based on changes in all types of corporate securities (regardless of the name of the plan) is similar to the treatment of stock options, stock appreciation rights, phantom stock plans, and junior stock conversions specifically addressed in FAR 31.205-6(i). The only costs that are allowable are those costs recognized on the measurement date (see 7-2123.2c.).

(b) Allowability of dividend payments prior to the September 24, 1996 revision to FAR 31.205-6(i) is determined by the nature of the stock awarded to the employee. In the Grumman case (ASBCA No. 34665, 90-1), the board found that dividends on restricted stock represent allowable compensation since the payments are contingent upon continuing employment. Therefore, such costs are allowable prior to the September 24, 1996 revision to FAR 31.205-6(i). Conversely, dividends paid on unrestricted stock vested in the employee are not allowable compensation costs under FAR 31.205-6 since employees have a right to receive the dividends as owners of the stock. Dividend payments on unrestricted stock represent a distribution of profits, not compensation for employee services.

e. The allowability of deferred compensation awards is subject to the provisions

of FAR 31.205-6(k) which stipulates that awards made in periods subsequent to the period when the work being remunerated was performed are not allowable. The costs of deferred compensation accruals are subject to the provisions of CAS 415, Accounting for the Cost of Deferred Compensation.

7-2124 Administrative Leave Due to Weather-Related Closures

When contractor personnel receive paid administrative leave due to inclement weather, the allowability and accounting treatment of such payments should be evaluated on a case-by-case basis in accordance with FAR 31.205-6. Paid absences are fringe benefits that, per FAR 31.205-6(m)(1), are allowable to the extent that they are reasonable in nature and amount and are required by law, employer-employee agreement, or an established policy of the contractor. The reasonableness of the amount paid is generally not an issue. The issue is whether or not the circumstances warranted the payment of administrative leave. Some factors to consider in determining reasonableness include the severity of the weather conditions and whether other businesses and organizations in the same geographical location were closed. The fact that the Federal government suspended similar operations in the area due to the weather generally would support that it was reasonable for the contractor to incur the administrative leave costs. If the costs are determined to be allowable, they should be charged in accordance with the contractor's disclosed or established cost accounting practice for charging paid absences.