This guidebook provides both audit guidance and "how to" assistance for audit procedures. The information contained in the "Audit Considerations" boxes should be considered "how to" assistance (i.e., information that auditors may want to consider), not mandatory guidance.

This guidebook has not been approved for public release.

Chapter 35 – Interest and Other Financial Costs

Authoritative Sources

FAR 31.205-20 Interest and Other Financial Costs

FAR 31.205-41 Taxes

Class Deviation 2011-O0006 Utilities Privatization-Class Deviation from FAR Part 31

FAR 31.205-27 Organization Costs

FAR 31.201-6 Accounting for unallowable costs.

This chapter provides general audit guidelines for auditing interest and other financial related costs. These costs include interest on borrowings, bond discounts, costs of financing and refinancing capital, legal and professional fees paid in connection with preparing prospectuses, and costs of preparing and issuing stock rights.

This chapter addresses the following topics:

35-1 General Information **

Generally, interest expenses and other financial costs are expressly unallowable and should be excluded from billings, claims, and proposals (FAR 31.201-6(a)). For more information on expressly unallowable costs see the Audit Alert on Identifying Expressly Unallowable Costs (19-PAC-002(R)). Unallowable interest expenses can include interest on loans and lines of credit. Bond discounts and all other costs of financing and refinancing capital, (net worth plus long-term liabilities), including associated costs, are also unallowable. Examples of associated costs include, but are not limited to, legal, accounting and other professional fees, incurred in connection with preparing a prospectus, and the costs of preparing and issuing stock rights.

35-2 Related Cost Principles. **

- FAR 31.205-10 Cost of Money – makes the costs of facilities and capital assets under construction allowable so long as the costs are appropriately imputed pursuant to CAS 414 or CAS 417.
- FAR 31.205-27 Organization Costs – FAR 31.205-27(a)(3), which is related to raising capital, excludes "short-term borrowings for working capital" from unallowable reorganization costs.
- FAR 31.205-28 Other Business Expenses.
    - This cost principle makes some of the administrative costs related to raising capital allowable (e.g. transfer charges resulting in the change of ownership of the contractor's securities).
    - Interest and penalties paid on unpaid taxes where non-payment was at the direction of the contracting officer are also allowable.

Audit Considerations: Relevant Case Law

Case law may be relevant to understanding a cost principle, but should never be used as a basis for questioning costs. Always use the relevant cost principle as a basis for questioning costs. This guidebook will provide case law that may assist the audit team in understanding the cost principle.

● The Federal Circuit found that the cost principle does not make all payments of interest unallowable, but only interest paid to raise capital is unallowable. It was determined that an inadvertent tax deficiency was not a method of raising capital, was not an intentional borrowing, and therefore, was not unallowable.

● The ASBCA held that the administrative fee paid by contractors for a line of credit is not unallowable interest under FAR 31.205-20 because it is not a borrowing, even if it is used as collateral for raising capital (like a bond). The court did leave open the possibility of questioning the line of credit costs for reasonableness.

● **Interest on Equitable Adjustment Claims.** While some courts have held that interest paid to third parties to finance changed work was a proper component of equitable adjustments, the incorporation of DFARS § 252.243-7001 Pricing of Contract Modifications clause, which makes applicable the FAR Cost Principles in FAR Part 31 and specifically FAR 31.205-20, means that the changes clause does not alter the allowability of interest.. Since the changes clause does not alter the cost principle, interest paid to finance changed work is unallowable under DFARS 252.243-7001 and FAR 31.205-20.

35-3 General Audit Guidelines **

Audit Considerations:

The audit team should remain alert to the potential existence of interest and other financial costs in contractor billings, claims, and proposals. If costs for interest are not recorded in an unallowable account, they may be recorded in accounts associated with items purchased or financed, such as equipment, or in unusual accounts such as supplies or software. If significant expressly unallowable costs are identified during an audit, and are pervasive (e.g.. spanning multiple years), the audit team should consider whether to report a noncompliance with CAS 405, Accounting for Unallowable Costs, in addition to the noncompliance with FAR 31.205-20.

Audit Considerations:

Leases

The Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 842 Leases is a new standard that governs the accounting for lease contracts for most public companies effective January 1, 2019 and most non-public companies in fiscal years starting after December 31, 2021 The new standard retains lease classifications, but the terms are operating and finance, rather than operating and capital leases. Although FAR has not been updated, the audit team should be aware of the change in terminology for GAAP reporting purposes. The GAAP change does not impact allowability under the FAR Cost Principles. If there are questions regarding the allowability of interest charges on a finance lease, after working with the audit team's technical specialist group, please contact HQ Policy, PIC at DCAA-PIC@dcaa.mil

35-3.1 Exceptions **

There are a few exceptions in which interest and financial costs could be allowable. Interest or penalties assessed by a State or local taxing authorities for non-payment of any tax at the direction of the contracting officer is allowable (FAR 31.205-41(a)(3)). However, any other interest or other costs associated with underpayment or late payment of obligations are unreasonable as under/late paying is not a prudent business practice in accordance with FAR 31.201-3(a).

Additionally, the administrative costs of short-term borrowings for working capital are allowable under FAR 31.205-27(a).

Audit Considerations:

An example of administrative costs of short-term borrowings for working capital would be a bank commitment fee to maintain a line of credit or a letter of credit that is renewed annually. Typically, fees such as these are considered short-term and normal costs of business. The audit team should consider whether the lines or letters of credit relate to an unallowable activity, such as a merger or acquisition (see FAR 31.205-27). In addition, the audit team should evaluate the reasonableness of such credit arrangements where the amount of available credit secured is far in excess of the amount needed to sustain normal business operations in the event of an emergency need for funds. The audit team should consider the maximum amount a contractor would need to sustain normal business operations in the event one or more emergencies affected the operations of the entire business. For example, natural disasters or a government shutdown for a contractor with high government participation could impact the ability of the contractor to make payments needed for continuing operations.

35-3.2 Utility Privatization Deviation **

Interest may be allowable, under certain circumstances pursuant to the provisions of Class Deviation 2011-O0006, Utility Privatization – Class Deviation from FAR 31, issued by Defense Procurement and Acquisition Policy dated March 31, 2011, on a contract awarded in conjunction with the conveyance of a utility systems under 10 U.S.C. §2688. The audit team should review the Class Deviation for the conditions to allowability when the contractor proposes interest costs that, subject to other conditions identified, are reasonable and related to the capital expenditures to acquire, renovate, upgrade, and expand the subject utility systems.

35-3.3 Purchase Card Merchant Fees **

Transaction fees relating to the acceptance of purchase cards for payment for goods and services are generally allowable as normal business expenses.

Many contractors allow purchasers, including the Government, to pay for purchases through the use of a purchase card (such as the Government Commercial Purchase 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 (e.g., VISA, 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.

35-3.4 Unallowable Bank Fees **

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, 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.

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Definitions

Commitment Fee – Fees charged for entering into an agreement that obligates the entity to make or acquire a loan or to satisfy an obligation of the other party under a specified condition. Commitment fees include fees for letters of credit and obligations to purchase a loan or group of loans and pass-through certificates. (Return)

Letter of Credit – There are several forms of this letter, but generally a letter of credit, or "credit letter" is a letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount. In the event that the buyer is unable to make a payment on the purchase, the bank will be required to cover the full or remaining amount of the purchase. (Return)

Line of Credit – A line of credit or revolving debt arrangement is an agreement that provides the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and to then re-borrow under the same contract. Line of credit and revolving debt arrangements may include both amount drawn by the debtor (a debt instrument) and a commitment by the creditor to make additional amounts available to the debtor under redefined terms (a loan commitment). (Return)