

SELECTED AREAS OF COST

Chapter 50 – Organization Costs

Authoritative Sources

[FAR 31.205-27](#) Organization costs

[FAR 31.205-6\(l\)](#) Compensation incidental to business acquisitions.

[FAR 31.205-41](#) Taxes

[FAR 31.205-47\(b\)](#) Costs related to legal and other proceedings

[FAR 31.205-33](#) Professional and consultant service costs

[DFARS 231.205-6\(f\)](#) Compensation for personal services

[FAR 31.205-12](#) Economic planning costs

[FAR 31.205-38](#) Selling Costs

This chapter provides general audit guidelines for auditing organization related costs. Such expenditures include, but are not limited to, incorporation fees and costs of attorneys, accountants, brokers, promoters, organizers, consultants, and investment counselors, whether or not they are employees of the contractor.

This chapter addresses the following topics:

50-1 General Information

50-2 General Audit Guidelines

50-3 Other Relevant Cost Principles

50-4 Economic Planning versus Organization Costs

50-1 General Information

Unallowable organization costs are costs incurred related to the organization or reorganization of the corporate structure of a business, including mergers and acquisitions (FAR 31.205-27).

Additionally, organizational cost includes cost related to partnerships. Accounting and legal fees incurred solely for the benefit of the principals are unallowable as follows:

- preparing a partnership agreement,

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- reviewing partnership contracts,
- obtaining permits,
- setting up partnership books, and
- filing partnership and individual tax returns.

50-2 General Audit Guidelines

Expenditures made in connection with planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions, are expressly unallowable under FAR 31.205-27(a). In establishing the coverage at FAR 31.205-27, the FAR Council 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...

Audit Considerations:

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. This is especially true at the executive level where the majority of the executive's time may be spent managing a corporate acquisition or reorganization. The auditor should ensure that the contractor implements and complies the necessary policies and procedures to properly identify and account for these activities.

Other costs the auditor should consider evaluating for allowability under FAR 31.205-27 include costs expended to redesign company marks, signs, logos, etc. due to a corporate merger or reorganization.

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.

50-3 Other Relevant Cost Principles

During an organization or reorganization of contractor's structure, related activities occur. Some of those costs may be unallowable under cost principles other than FAR 31.205-27. The audit team should consider other types of related costs that the contractor may incur. The list below includes some, but not all, of these type of costs and applicable regulations (i.e. FAR Cost Principle, DFARS).

- **FAR 31.205-6 Compensation for Personal Services** - FAR 31.205-27 was not intended to limit or inhibit the methods or amounts paid as compensation. Therefore, FAR 31.205-6 should be consulted for such costs as Employee Stock Ownership Plans, Executive Compensation, and Employee Savings Plans that may be paid in conjunction with a merger or acquisition. See FAR 31.206-6(f)(1) Bonus and Incentive Compensation, and FAR 31.205-6(l) Compensation Incidental to Business Acquisitions.

FAR 31.205-12 Economic Planning Costs - Makes long range economic planning concerning future overall development of the contractor's business allowable.

- **FAR 31.205-28 Other Business Expenses** - Makes certain regularly recurring costs allowable, like the costs resulting from the transfer of ownership of securities issued by the contractor, the cost of shareholder and director meetings, and publishing reports to shareholders.
- **FAR 31.205-38 Selling Costs** - Defines "Market Planning" as market research and analysis and general management planning concerned with development of the contractor's business. Indicates that long-range planning is subject to the allowability provisions of FAR 31.205-12, but other market planning costs are allowable.
- **FAR 31.205-47(f)(2) Legal Costs** - Makes unallowable legal costs resulting from organizations, reorganizations, mergers, and acquisitions, or resisting mergers and acquisitions.
- **FAR 31.205-49 Goodwill** - Makes unallowable the amortizing, expensing, write-off or write-down of goodwill. Goodwill is the difference between the excess price paid and the sum of the value of the acquired assets less liabilities in a business combination.
- **FAR 42.1204 Applicability of Novation Agreements** - Novation Agreement requires agreement by contractors that the Government is not obligated to pay or reimburse any costs, taxes, or other expenses, or any relate increases, directly or indirectly arising out of or resulting from the transfer or Agreement.

- **DFARS 231.205-70 External Restructuring Costs** - This provision limits the allowability of certain costs resulting from restructuring activities that result from the merger, acquisition, or sale/purchase of assets and the resulting combination of the operations of two companies not previously under common control. A restructuring activity is a non-routine, non-recurring or extraordinary activity to combine operations to eliminate redundancy, improve operations, and reduce costs. This clause permits contractors to charge restructuring costs to the Government if the contractor can demonstrate that the projected savings for DOD resulting from the restructuring will exceed a 2 to 1 factor.

Audit Considerations:

The audit team should be alert to the possibility that a reorganization could result in idle facilities and/or idle capacity costs. FAR 31.205-17 contains requirements related to these types of cost.

Audit Considerations: Compensation Costs

With respect to FAR 31.205-6(l)(2), 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 \$150,000 per year, but for good reason, (e.g., to help the company through a rough financial period) the employee accepted and was paid only \$120,000 per year. If the new owners immediately raise the individual's salary to \$150,000, 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. A golden handcuff is special compensation, which is contingent upon the employee remaining with the contractor for a specified period of time following a change in control of the company.

Audit Considerations: Restructuring Costs

The audit team should be alert for unallowable organization or reorganization costs (FAR 31.205-27) that the contractor may have included in the its 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.

Audit Considerations: External Restructuring Cost (DFARS 231.205-70)

Organization and Reorganization cost (per FAR) and External Restructuring Costs (per DFARS) are those incurred during one-time activities that are non-routine and nonrecurring events where the cost would not have been incurred but for the reorganization or restructuring. These principles do not include routine business costs like the rearrangement of a production line to make the line more efficient. Most court cases involving FAR 31.205-27 Organization Costs have centered on raising capital and changes to the “financial” structure of the corporation.

Costs that result in the merger or reorganization of the company but do not affect the equity interests of shareholders may also be unallowable as a change in corporate structure. An example would be a corporate merger of wholly owned subsidiaries of a company, which results in the formation of one separate corporate subsidiary but does not change the equity interests of shareholders of the parent company would be a change of the corporate structure that is covered by the cost principle.

It is also important to distinguish between the FAR Organization and Reorganization costs and External Restructuring costs that are subject to the DFARS rule. The FAR cost principle identifies costs such as “incorporation fees and costs of attorneys, accountants, brokers promoters and organizers, management consultants and investment counsellors, whether or not employees of the contractor.” Therefore, these would be limited to the costs of planning and executing a merger or acquisition and the costs of incorporating the new entities and establishing the equity financing for the business. Whereas, the DFARS External Restructuring costs are those costs that are allowable under FAR cost principle, but are one-time costs of accomplishing the business combination. The DFARS identifies the following examples of restructuring activities: non-routine, nonrecurring, or extraordinary activities to combine facilities, operations or workforce to eliminate redundant capabilities, improve future operations, and reduce overall costs. The DFARS does not include normal or routine plant rearrangement or employee relocation activities.

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.

- ASBCA determined that a redemption of 4-1/2% debentures for stock and a stock split were a capital adjustment rather than a reorganization of the capital structure and were allowable under ASPR 15-205.23 (ASPR is the Armed Services Procurement Regulations is the precursor to FAR). The 1976 changes to the cost principle specifically address this case and would now make these costs unallowable.
- In another case, the ASBCA looked at the distinction between market planning and organization or reorganization costs. The Board suggested that reading FAR 31.205-27 and FAR 31.205-38 Selling Costs together, “the intent appears to be that costs in connection with actually planning the organization or reorganization of a business, such as by a specific merger or acquisition, are unallowable whereas generalized long-range management planning costs are allowable.” The decision cites to a “learned treatise” to observe that Economic Planning Costs are “the costs of surveying various business opportunities, making demographic and economic studies, and evaluating potential markets or firms for mergers or acquisitions would be allowable. Conversely, once a target has been identified, the costs of planning or executing organizational changes would be unallowable.” The Board determined that the development costs of a database, while intended for both long range planning and specific mergers and acquisitions, was never used for mergers and acquisitions and therefore the costs of the database were allowable market planning costs.

50-4 Economic Planning versus Organization Costs

Economic planning costs are allowable under Government contracts, in accordance with FAR 31.205-12. However, allowable economic planning costs do not include organization or reorganization costs. Costs incurred for market research and analysis and general management planning concerned with development of the contractor's business are also allowable under FAR 31.205-38 Selling Costs. Often times, the distinction between allowable economic planning costs and unallowable planning for the organization or reorganization is not very clear.

Cost incurred for actually planning the organization or reorganization of a business, such as by a specific merger or acquisition, are unallowable in accordance with FAR 31.205-27. However, generalized long-range management planning costs were allowable in accordance with FAR 31.205-12 Economic Planning Costs. The costs of

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surveying various business opportunities, making demographic and economic studies, and evaluating potential markets or firms for mergers or acquisitions would be allowable. On the contrary, once a target for mergers or acquisition has been identified, the costs of planning or executing organizational changes would be unallowable.

Audit Considerations:

The point where economic planning becomes unallowable organization activity can be difficult to determine. Generally, the difference between what is allowable versus what is unallowable can be summarized as follows:

- Costs incurred for general planning are allowable.
- Costs incurred to initiate or change the current organization to meet future market conditions are unallowable.