

SELECTED AREAS OF COST

Chapter 65 - Selling Costs

Authoritative Sources

[FAR 31.205-38](#) Selling Costs

[DFARS 225.7303-2](#) Cost of Doing Business with a Foreign Government or an International Organization

[DFARS 225.7303-4](#) Contingent Fees

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

- Selling costs as discussed in FAR 31.205-38,
- Selling costs under Foreign Military Sales contracts as discussed in DoD FAR Supplement (DFARS) 225.7303-2 and 225.7303-4, and
- Contingent fees as discussed in FAR 3.400.

This chapter addresses the following topics:

65-1 General Audit Considerations

65-2 Proper Classification of Selling Expenses

65-3 Allocability of Selling Cost

65-4 Reasonableness of Selling Cost

65-5 Allowability of Selling Cost

64-6 Selling Cost Under Foreign Military Sales (FMS) Contracts

65-1 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.

65-2 Proper Classification of Selling Expenses

65-2.1 Nature of Selling Effort

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).

Costs of activities which are correctly classified and disallowed under the above cost principles should not be considered as allowable costs under FAR 31.205-38 or any other subsection of FAR 31.205.

65-2.2 Illustration 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:

(1) 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

- (a) development of a new cooling concept;
- (b) development of a new mechanical configuration and installation concept;
- (c) installation analysis of electrical power requirements; and
- (d) 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.

(2) 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.

65-2.3 Audit Techniques to Identify Improperly Classified Selling Costs

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

(1) Floor checks and interviews of contractor personnel.

(2) 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.

(3) 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.

(4) Technical assistance which may be useful in determining the proper classification of selling effort.

65-3 Allocability of Selling Costs

65-3.1 General Allocability Considerations

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 CAM Section 6-606 regarding allocability.

FAR 31.202(a) and 31.203(b) 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.

FAR 31.203(c) 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.

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 representing 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 CAM Section 8-410.

65-3.2 Special Considerations for Allocability of Selling Costs

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.

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.

65-4 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:

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.

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 therefore 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.

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 information 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.

65-5 Allowability of Selling Cost

65-5.1 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 CAM Section 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. Costs that have been made expressly unallowable by other subsections of FAR 31.205 should not be considered as allowable selling costs under 31.205-38 (see 65-2). Auditors should screen selling costs to ensure that contractors

have properly identified and segregated the expressly unallowable costs discussed in the sections that follow.

65-5.2 Foreign Selling Costs

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 are allowable on U.S. Government contracts. Effective August 25, 2003, FAR 31.205-38 was revised to remove the distinction between the allowability of foreign and domestic selling costs involving direct selling and market planning efforts other than long range planning. This eliminates the requirement that foreign selling costs must be related to products normally sold to the U.S. Government to be allowable. However, distinguishing between foreign and domestic broadly targeted sales efforts remain unchanged. The allowability of these costs are covered in FAR 31.205-1 (see Chapter 1, Advertising and Public Relations).

65-5.3 Sellers' or Agents' Compensation, Fees, Commissions, etc.

FAR 31.205-38(c) 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 65-6 below). 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 (c)). 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.

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.

65-6 Selling Costs Under Foreign Military Sales (FMS) Contracts

65-6.1 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.

65-6.2 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).

65-6.3 Audit considerations

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.

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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.

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.

Costs of sales agents' commissions or fees under FMS contracts are subject to the allowability criteria as specified in FAR 31.205-38(c) (see 65-5.3). 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 (c), 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.

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.

According to DFARS 225.7303-2(e), the limitations specified in DFARS 231.205-1 on the allowability of costs associated with leasing Government equipment does not apply to FMS contracts.

65-6.4 Foreign Military Sales (FMS) Offset Arrangements

The purpose of an FMS offset arrangement is to fulfill commitments negotiated pursuant to an FMS agreement. The general policy in fulfilling these commitments 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.

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)).