

Determining Defense Contract Unallowable Costs Under CRAG

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Determining Defense Contract Unallowable Costs Under CRAG

As political leaders search for ways to bring a commonsense approach to federal procurement through increased regulation and oversight, compliance with the burgeoning bureaucracy continues to be a major concern for corporate managers. Likewise, government officials are struggling to manage regulatory oversight in light of the expanded complexity. In an attempt to answer this challenge they are trying, through incentive programs, to induce contractors to shoulder more of the oversight responsibility.

One of these incentive approaches to contractor compliance was developed by the Department of Defense and is known as the Contractor Risk Assessment Guide & Program (CRAG). As envisioned, the CRAG tempts contractors with the benefits of reduced government oversight if voluntary compliance programs are implemented. The CRAG addresses several compliance issues, including that of unallowable costs.

Unallowable costs are discussed in that section of the CRAG on indirect cost submissions. However, in its coverage the CRAG addresses only a few of the elements that should be considered for unallowable costs, specifically, it emphasizes the allowability of certain selected costs, allocability of costs in general, contractor compliance reviews of company policies and procedures, and internal audits related to indirect cost submissions.

A previous article,¹ described the accounting treatment of unallowable costs and the procedures that should be adopted by internal auditors for conducting contractor compliance reviews. This article examines the critical first step of any contractor compliance program or audit procedure concerned with unallowable costs determining unallowable costs.

Determining Unallowable Costs

For the most part, unallowable costs are described in the Federal Acquisition Regulations (FAR) (48 C.F.R. Pt. 31). In certain areas such as nonprofit organizations and educational institutions the discussion of unallowable costs extends outside of the FAR to various Office of Management and Budget (OMB) circulars but unallowable costs for commercial contractors are

covered completely in the FAR. Although many aspects of cost allowability are described in Part 31, the criteria for cost allowability are explained in FAR Section 31.201-2. Specifically, five factors are to be considered when determining cost allowability. These factors are reasonableness, allocability, terms of the contract, limitations set forth in FAR Subpart 31.2, and "standards promulgated by the CAS (Cost Accounting Standards) board if applicable; otherwise generally accepted accounting principles and practices appropriate to the particular circumstances." Each of these five tests is discussed below.

Reasonableness of Costs

Reasonableness is one of the five tests for determining cost allowability. FAR Section 31.201-3 defines reasonableness as follows:

A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business. What is reasonable depends upon a variety of considerations and circumstances involving both the nature and amount of the cost in question. In determining reasonableness of a specific cost, the contracting officer shall consider:

- A. Whether it is the type of costs generally recognized as ordinary and necessary for the conduct of the contractor's business or the contract performance.
- B. The restraints or requirements imposed by such factors as generally accepted sound business practices, arm's-length bargaining, federal and state laws and regulations, and contract terms and specifications.
- C. The action that a prudent businessperson, considering responsibilities to the owners of the business, employees, customers, the government, and the public at large, would take under the circumstances; and
- D. Any significant deviations from the established practices of the contractor that may unjustifiably increase the contract costs.

The concept of reasonableness is often times a difficult subject. As is usual in the case of reasonableness definitions, abstract concepts such as "prudent man" and "sound business practices clutter" the landscape for many professionals. Nevertheless, reasonableness is a fundamental requirement for cost allowability and an area where disputes between contractors and the

government have occurred frequently. As a result of these numerous debates, several distinctions have been made with regard to cost reasonableness.

First, incurred costs are generally considered reasonable in nature and amount. The mere fact that the costs were incurred usually means that they were necessary for the performance of the contract or the conduct of the contractor's business. Nevertheless, government officials frequently try to second guess the contractor and substitute their own judgment for his. In other cases the government may disallow costs solely because it believes the costs to be unreasonable in amount. In either of these kinds of instances the government normally will not prevail. The government cannot disallow costs merely because it believes that the costs should not have been incurred. After all, the concept of reasonableness requires consideration of the facts and circumstances particular to the situation and depends on the exercise of business judgment.

Second, despite the fact that incurred costs are generally considered reasonable, they may in some cases be unreasonable. If the government determines that costs are unreasonable, then the regulations (FAR § 31.201-3(a)) place the burden of proving cost reasonableness squarely on the shoulders of the contractor. If an initial review of the facts results in a challenge of a specific cost by the contracting officer or the contracting officer's representative, the burden of proof shall be upon the contractor to establish that such cost is reasonable. In order to prove reasonableness or, inversely, unreasonableness, one must focus on the contractor's actions or inactions that permitted the costs. Thus, the amount of the cost itself should never be the basis for allowance or disallowance. The actions or inactions of a contractor that will result in the disallowance of costs are of two categories. The two categories are when the contractor performs the contract and incurs costs that are excessive when one considers the facts and circumstances at the time or when the contractor performs the contract without regard to the government's financial interest. In either case, the contractor's actions or inactions contribute to the incurrence of costs that were unnecessary. In *Air Repair G.M.B.H.* (ASBCA 10288), a contractor failed to take advantage of cash discounts when paying invoices for a cost-reimbursable contract. The contractor's actions were considered unreasonable because the government had made payments to the contractor for those invoices prior to the expiration of the discount period. Thus, the costs of the lost discounts were considered unnecessary and caused by actions or inactions of the contractor that failed to consider the government's financial interest. Another area of unnecessary costs can be seen in recent controversies regarding the techniques used by government contractors for planning material purchases. Many contractors have made it a policy to purchase all materials for a government contract upon receipt of the contract award. This may happen even though the contract performance period is very long and the items being purchased do

not have long lead times. In addition, this practice is contrary to the contractor's regular purchasing practices for commercial products having the same or similar materials. For cost-reimbursable contracts or fixed-price contracts with progress payments, these practices accelerate cash flows to the contractor at government expense. After all, there is an element of time value of money, as well as the related costs of storing and handling materials that might not otherwise be used until sometime in the future. The condition may even be further aggravated if the contractor then uses those materials, which were purchased for government contracts and reimbursed with government money, in commercial contracts and subsequently replaces the borrowed materials. The ultimate outcome may be the same but the costs incurred by the government contract may have been unnecessary and incurred only to benefit the commercial contracts, without regard for the government's financial interest.

In all, there are no established guidelines that can be routinely employed to determine cost reasonableness and thus cost allowability. Rather, the notion of reasonableness requires the examination of facts and circumstances peculiar to each case along with the contractor's actions or inactions precipitating the costs. Thus, judgment and professional expertise must be exercised when deciding whether or not costs are reasonable.

Cost Allocability

The second of the five tests for determining cost allowability is cost allocability. This element is also one of the areas emphasized in the CRAG. However, the test of allocability, as used here, is not concerned with the mechanics of cost allocation but, instead, with the rationale for allocating costs to government contracts. The mechanics of cost allocation, which is also addressed in the CRAG, are discussed in a later section of this article which explains how costs are allocated to contracts.

For costs to be allocable they must meet at least one of the three criteria provided in FAR Section 31.201-4 defining cost allocability:

" A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship. Subject to the foregoing, a cost is allocable to a government contract if it-

- (a) Is incurred specifically for the contract;
- (b) Benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; or
- (c) Is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown."

Thus, the test of a cost's allocability is a test of benefit and necessity. The test of benefit has been construed in both a very narrow and a very broad interpretation. The narrow interpretation requires that the costs benefit government work as well as other work. A cost that would not benefit government work would of course be unallowable. An example of this kind of unallowable cost might include the cost of postage for mailing catalogues of commercial products that are not purchased by the government.

However, the courts and administrative boards have tended to analyze the allocability test by using a broader interpretation of benefit. In *Lockheed Aircraft Corp. v. United States* (179 Ct. Cl. 545, 375 F.2d 786 (1967)), the court of claims perceived that Lockheed's payment of state and local personal property taxes on commercial inventory benefitted government contracts by virtue of the services provided by the community with the tax money collected. In another case, *Dynalectron Corporation* (ASBCA 20240, 77-2 BCA 11 12,835), the board perceived that the government benefitted from a contractor's purchase of an unrelated entity since the new entity expanded the cost allocation bases and, therefore, reduced the indirect costs allocated to government contracts. Thus, when evaluating the benefits provided by an incurred cost one must consider the costs in both a micro and macro context.

The test of necessity is different than the test of benefit. This test essentially requires that for costs to be allocable they must be necessary for the continued operation of the contractor's business. Despite its ominous sound, the test of necessity has not been interpreted to require absolute necessity for the operation of a contractor's business. However, in *TRW System Group of TRW, Inc.* (ASBCA 11499, 68-2 BCA 11 7117), the board recognized that as costs become less necessary for the conduct of a contractor's business the burden for showing some other kind of benefit to a contractor's business increases. In short, the test of necessity can be likened to the test of benefit in that the company's continued existence is benefitted by the costs incurred.

Just as with the test of reasonableness, the test of allocability requires the use of judgment and experience when determining whether a cost is allowable. The effort required in making this determination may involve considering causes and effects that extend beyond the cost itself and include an analysis of the benefit to the company as a whole.

Terms of the Contract

The third test for determining cost allowability is whether the costs comply with the terms of the contract. Limitations on costs are frequent occurrences in government contracting. The limitations of costs occur in two basic forms.

The first form is the limitation of specific types of costs such as travel, reproduction, special tooling and test equipment, consultants, and allocated indirect costs, to name a few. Virtually any type of cost can be limited by the terms of the contract. Furthermore, the costs can be limited in terms of amount or mix. For example, a service contract could limit the amount of outside consultant expenses to a certain dollar amount or the contract terms could specify that a certain amount of the costs incurred for consultants must be for a specific consultant or type of consultant.

The limitation of costs imposed by the contract's terms can also limit a cost's allowability by requiring the performance of a specific act by the contractor.

For example, the terms of the contract could require the contractor to obtain government approval prior to incurring a particular cost. Likewise, the contract could require that the contractor perform certain tasks, such as performing final inspection on all items manufactured under the contract, in order for the costs to be allowable. Naturally, such provisions could reside outside the signed contract document and be contained in the contract specifications.

The second form of cost limitation is found in certain required contract clauses. A few examples of these clauses are the limitation-of-cost clause (FAR §§ 52.232-20 and 52.232-21), the limitation-of-funds clause (FAR § 52.232-22), and a variety of notification clauses such as the notification-of-changes clause (FAR § 52.243-7). The limitation-of-cost clause is a required contract clause for fully funded cost-reimbursable contracts. The limitation-of-funds clause is a required clause for incrementally funded cost-reimbursable contracts. The importance of these clauses is that they limit the government's responsibility to reimburse the contractor in the event of a cost overrun or the expiration of obligated funds. Thus, a contractor that exceeds the limitations provided in these clauses and does not comply with their requirements would not be able to recover these excess costs should the government decide to terminate the contract for its convenience. Similarly, the notification clauses require the contractor to inform the government of certain events that could affect contract costs, such as a contract change. Should the contractor fail to comply with the notification provisions, the contractor could be prevented from recovering its increased costs.

Due to the potential for specific contract provisions that can dictate cost allowability, company cost procedures should include a review of contract requirements. Moreover, cost and contract administration systems should be designed to identify, capture, and monitor costs restricted by contract provision.

Costs Covered by Regulation

The FAR recognizes that differences exist in contracting practices between various professions and contract circumstances. With this in mind, the FAR provides for differing cost principles for commercial organizations, educational institutions, construction contracts, facilities contracts, nonprofit organizations, and state and local governments. Although there are some nuances for each of these areas, almost all of these areas incorporate the limitations set forth in FAR Subpart 31.2.

In FAR Subpart 31.2 numerous cost concepts are described. These concepts include the composition of costs, the five tests for cost allowability that are described throughout this article, the treatment of cost credits, the accounting treatment of unallowable costs that is described in the next section of this article, a description of direct and indirect cost, and the allowability of fifty-one different cost types. Each of these areas is significant in the determination and handling of unallowable costs.

The Composition of Costs

FAR Section 31.201 describes the composition of costs. The importance of this section lies in the following language contained in that section. In ascertaining what constitutes a cost, any generally accepted method of determining or estimating costs that is equitable and is consistently applied may be used..."

The key terms in this language are the words "equitable" and "consistent." The word "equitable" can be interpreted to be similar to the interpretation of allocable. However, equitable can encompass more than a determination that a cost is allocable to government contracts. Equitable can also refer to the mechanics of how the allocation of costs was performed and to the fact that the allocation "equitably" distributes costs to cost objectives in accordance with their causal beneficial relationships. Thus, any increased costs, unless required by the terms of the contract, that are allocated to contracts under an unequitable method, as, compared with an equitable method, would be unallowable for government contracting purposes.

Unequitable allocation methods frequently occur in the area of uncompensated overtime. If direct charge salaried employees perform overtime but only account for their regular salary hours, this can result in an unequitable allocation of costs.

The term "consistent" requires that the contractor estimate and accumulate costs consistently and that costs incurred for like purposes and in similar circumstances be accounted for consistently regardless of contract type. This means that any increased costs, unless required by the terms of the contract, allocated to contracts as a result of a contractor's inconsistent accounting treatment would be unallowable for government contracting purposes.² For example, if a contractor allocated the travel costs of production workers on cost-reimbursable contracts as a direct charge but allocated those same types of costs as an indirect charge on fixed-price contracts, this would be an inconsistent practice and one that would result in unallowable costs.

Accounting for Credits

The FAR even describes the special accounting requirements for cost credits. The required accounting treatment for credits is discussed in FAR Section 31.201-5: , 'The applicable portion of any income, rebate, allowance, or other credit relating to any allowable cost and received by or accruing to the contractor shall be credited to the Government either as a cost reduction or by cash refund.'

Essentially, this passage in the regulation requires that cost credits be given the same consideration as was the initially incurred cost. A credit for a direct cost is allocated to the same cost objective as was the initial direct cost. Likewise, credits for indirect costs should be allocated to the same indirect cost pools as the originally incurred costs.

A critical term used in the FAR passage, though, is the phrase "applicable portion." For example, consider the case where a depreciable asset has been sold for more than its original acquisition cost. In such a case, the applicable portion of any cost credit for accumulated depreciation would be the difference between the asset's book value and its acquisition price.

Regard to cost credits, added confusion can occur when the cost incurred was recognized in a period other than when the credit was issued. In such cases, one can usually follow the requirements in generally accepted accounting principles (GAAP) for accounting changes and prior period adjustments as a basis for determining the correct accounting period for recognizing cost credits. As an example, consider a credit caused by a change in accounting estimates that results in again on sale of a depreciable asset. In such a case, the resulting credit would be recognized in current and future accounting periods as required by GAAP. No restatement of prior periods would be required. Compare this example to one involving a tax credit from a loss carry back. In the case of a tax credit resulting from a loss carry back the correct treatment, for government contracting purposes, is to recognize the

credit in the year that the tax was originally recognized.³ The regulations, however, require that refunded tax credits be credited or paid in the manner directed by the government.⁴

Thus, failing to recognize cost credits for costs that had originally been considered for allocation to government contracts can result in unallowable costs to the extent of the credit for the accounting period in which the credit should have been allocated.

Allocating Costs to Contracts

The importance of cost allocation to contracts cannot be overemphasized because in government contracting, unlike commercial contracting, all costs are allocated. This includes both direct and indirect costs. In commercial contracting many costs are considered period costs and, therefore, expensed in the income statement as a selling and administrative cost. They are, therefore, never allocated to final cost objectives. In government contracting, however, a full absorption method is employed. This allows all costs to be allocated to final cost objectives usually contracts.

FAR Section 31.202 defines direct costs as those costs that can be identified with only one final cost objective. For reasons of practicality, FAR section 31.202(b) also allows direct costs to be allocated to final cost objectives as an indirect cost if the accounting treatment is consistently applied and results in substantially the same outcome as treating the cost as a direct cost.

FAR Section 31.103 defines indirect costs as those costs that can be identified with two or more final cost objectives. Since indirect costs are shared by more than one final cost objective, they are allocated to the benefitting cost objectives using a multi step procedure. This procedure is also described in the FAR section on indirect costs.

When allocating indirect cost they, first, are collected into homogeneous groupings called cost pools. The term "homogeneous" means that they share a causal beneficial relationship with a common allocation base. That is, amounts in the cost pool vary directly with a single cost or collection of costs outside of the cost pool. For example, the pool of fringe benefits for production workers might share a causal beneficial relationship with the costs of direct labor.

Next, a ratio, called an indirect cost allocation rate, is calculated that quantifies the relationship of the cost pool and its base. (The fringe benefit cost pool is divided by the amount of direct production labor.) Furthermore, FAR Section 31.203(c) requires that once a base has been selected, "it shall

not be fragmented by removing individual elements" from the base, and that "all items properly includable in a base should bear a pro rata share of the indirect costs."⁵ Finally, to determine the amount of indirect costs allocated to each final cost objective this ratio is multiplied by the amount of base cost incurred by each final cost objective.

Considering that the cost pools must consist of homogeneous costs, it is quite possible for many cost pools to exist. Furthermore, the costs allocated from one cost pool may be an element in the base on which to allocate other indirect costs. Such is the case for indirect plant costs versus indirect general and administrative costs. Indirect manufacturing costs share a causal beneficial relationship with a manufacturing base, but indirect general and administrative costs share a causal beneficial relationship with all costs incurred for the management of the company. Therefore, allocated indirect manufacturing costs could be a component in the base on which to allocate indirect general and administrative costs. Thus, costs that are incurred in like circumstances and for similar purposes but are not consistently treated as direct or indirect, or which are inequitably allocated using the company's indirect cost structure, can be unallowable for government contracting purposes.

Specifically Identified Costs

In FAR Section 31.205, fifty-one cost types are specifically identified. These fifty-one costs can be categorized into two groups. The two groups are those costs that are entirely unallowable and those that are conditionally allowable.

The first group, costs that are entirely unallowable are perhaps the best known facet of government contracting. In all there are thirteen types of costs that are entirely unallowable. These include bad debts, advertising, entertainment, losses on other contracts, and interest expense to name a few.

Although government officials provide numerous reasons why these costs should be unallowable for government contracts, the only real reason is that they have been determined unallowable by regulation. For example, a government official might explain the fact that bad debts are entirely unallowable by saying that they fail the test of allocability. Since the government always pays its debts, the government official could conclude that bad debt expenses are not allocable to government contracts.

However, under the benefit test, bad debts could easily be allocable to government contracts. If government contracts benefitted from absorption of fixed costs by an increased allocation base resulting from commercial operations, then the costs of those operations, including bad debts, should be

allocable to government contracts. Nevertheless, these costs have been determined by regulation to be totally unallowable.

The second group of costs has conditional allowability. In this group are the remaining thirty-eight of the fifty-one cost types covered in FAR Section 31.205. The thirty-eight types of costs include taxes, rents, depreciation, special tooling and test equipment, independent research and development, bid and proposal costs, and travel costs, to name a few. For these costs to be allowable, certain conditions must occur or be required under the contract or the contractor must account for the costs in a specified manner.

For example, bonding costs (FAR § 31.205-4) are allowed if the contractor is required to furnish a bond pursuant to the terms of the contract or if bonding is in accordance with sound business practices. On the other hand, economic planning costs (FAR § 31.205-12) are not an allowable direct cost but "are allowable as indirect cost to be properly allocated."

Familiarity with these fifty-one cost types and their treatment will be vital for anyone involved with government contracting. The CRAG urges contractors to give special attention to nine of these fifty-one cost types. These nine are: entertainment expenses; independent research and development costs; bid and proposal costs; legislative lobbying costs; professional and consultant service costs; relocation costs; selling costs; travel costs; and trade, business, technical, and professional activity costs.

Cost Accounting Standards and GAAP

The fifth test for determining cost allowability requires consideration of the cost accounting standards (CAS), GAAP, and other practices considered appropriate for the circumstances.

There are nineteen CAS. Their use and application to certain negotiated National Defense contracts are documented in 4 C.F.R. Chapter. III Subch. C through G. Although initially intended for use in certain negotiated National Defense contracts, the CAS have been incorporated into the FAR and are extended to civilian contracts as a matter of policy.⁶

In addition to the nineteen cost accounting standards, there is a requirement that certain contractors performing CAS-covered contracts disclose in writing their cost accounting practices. The contractor is then required to follow these practices consistently.

FAR Part 30 discusses the CAS and the requirement for contractors to disclose their cost accounting practices. The specific application of the cost

accounting standards to negotiated civilian contracts is discussed in FAR Section 30.201-1.

While FAR Part 31 determines a cost's specific allowability, the CAS govern the accounting treatment and the allocation of costs within a contractor's accounting system. Any increased costs allocated to government contracts in a manner that is contrary to the practices described by the standards or in a manner that is contrary to the contractor's disclosed accounting practices are unallowable.

Similar constraints to cost allowability exist when a contractor's cost accounting practices are contrary to other accounting standards such as GAAP . One such example is the treatment of capital leases. In accounting for leases, both the FAR and the CAS look to the guidance of Financial Accounting Standard No. 13 for the proper accounting treatment and the allowability of cost related to leases.

Another example of the importance of GAAP in government contract costing involves the contractor's basis of accounting. For government contract costing the contractor must use the accrual method. This requirement is directly attributable to the requirement for accrual accounting under GAAP

A detailed discussion of the nineteen CAS along with the various generally accepted accounting principles is beyond the scope of this writing. Nevertheless, company employees should be aware of the significance of these standards for determining the allowability of costs and the cost accounting practices adopted by the company for government contracting.

Conclusion

Federal government contracting is a highly regulated industry. The contract cost principles and the five tests for determining cost allowability represent only a portion of the total procurement regulations and compliance issues; nevertheless, this portion presents employees and company managers with plenty to consider.

As a result of the many criteria for determining allowable costs, including the exercise of judgment based on facts and circumstances peculiar to each case, a contractor's compliance system for unallowable costs cannot rely on the identification of these costs merely from account titles in the general ledger. Neither can they depend on a centralized, transaction-based, after the fact review function. Instead, the system should be decentralized and reside at some control point that is in close proximity to where the transaction is authorized and approved. Furthermore, the compliance system must provide

for a formal documentation process when the determination of cost allowability is not readily apparent on the face of the transaction itself.

Company employees charged with making the determination of cost allowability and internal auditors reviewing the company's policies and procedures should be adequately trained in the many intricacies of this subject. Also, they must realize that their responsibility extends beyond merely determining that a cost was incurred. Indeed, they will need to determine that the costs were incurred and that they were allowable. In order to determine allowability they will first have to determine whether the costs are specifically allowable or unallowable under regulation and under the terms of the contract. Next, they will have to determine whether the costs were reasonable and if they were of benefit to the contract or necessary to the company as a whole. Finally, even if all of these criteria are met, reviewers must still consider the accounting treatment of the costs. More specifically, they will have to determine whether the costs are being allocated and accounted for in accordance with regulation and with various accounting standards such as the CAS or GAAP, and that they have been allocated in a fair and equitable manner.

End Notes

1. Fordham. .." Auditing Unallowable Costs of Government Contracts" Internal Auditing 5 (Summer 1989): 12.
2. An inconsistent accounting practice required by the terms of the contract may not increase the cost of the contract to the government
3. Grumman Aerospace Corp. v. United States, 217 Ct. Cl. 285. 579 F.2d 586 (1979).
4. FAR § 31.-05-41(d).
5. This requirement is specifically mentioned in the CRAG.
6. Pub. L. No.100-679 amended the Office of Federal Procurement Policy (OFPP) Act so that the Cost Accounting Standards Board is reinstated and so that the CAS will be applicable to all negotiated federal contracts over \$500,000; however, the law allows the OFPP administrator 180 days after November 17, 1988. in which to determine the implementation of these new requirements. As of June 1, 1989, an OFPP administrator had yet not been selected.