Offsets are hard.

But before we get into the hows and whys and wherefores of accounting for offsets, we'd better start by defining them.

Offsets (according to the DFARS) are "the entire range of industrial and commercial benefits provided to foreign governments as an inducement or condition to purchase military supplies or services, including benefits such as coproduction, licensed production, subcontracting, technology transfer, in-county procurement, marketing and financial assistance, and joint ventures."

Offsets arise in the context of Foreign Military Sales (FMS). We've written a primer on FMS-related stuff on this blog before (link **here**). There is also a DPAP slide presentation on the role of FMS in national security available in our Knowledge Resources (to members of the site). In essence, offsets are the part of the deal that's other than the item or service being provided.

Typically an offset involves a requirement to purchase of something from the country that's buying the goods/services from the U.S. contractor. Often the U.S. contractor is expected to enter into a contract with the foreign company as part of the overall FMS deal. When the contract between the U.S. contractor and the foreign company is a subcontract (i.e., in support of the prime FMS contract) then we are dealing with a "direct" offset agreement. When the contract is not a subcontract, then we are dealing with an "indirect" offset agreement.

But offset agreements can include requirements other than an agreement to acquire good and/or services. Offset agreements can also include coproduction, licensed production, technology transfer, marketing and financial assistance, and joint ventures. Some of that stuff is easier to account for than other stuff. For example, marketing costs are fairly easy to handle—though we strongly suspect there will be some significant FCPA hurdles to leap over. But from an accounting view, the effort should be easy to handle.

Challenges arise when the offset agreement requires in-country procurements (use of local businesses) or subcontracts under the “prime” FMS contract. The primary challenge is in the pricing of the FMS deal that includes the offset subcontracts. The DFARS (at subpart 225.70303) requires that FMS contracts must be priced “using the same principles used in the pricing of other defense contracts.” The DFARS states –

If the contractor has made sales of the item required for the foreign military sale to foreign customers under comparable conditions, including quantity and delivery, price the FMS contract in accordance with FAR Part 15.

The DFARS also provides that the contractor can include “the reasonable and allocable costs of doing business with a foreign government … even though such costs might not be recognized in the same amounts in pricing other defense contracts.” In particular, “A U.S. defense contractor may recover all costs incurred for offset agreements with a foreign government or international organization if the LOA [Letter of Offer and Acceptance] is financed wholly with customer cash or repayable foreign military finance credits.” Clearly, then, the reasonable and allocable costs of direct offsets, including some costs not normally recognized as being fully allowable in other circumstances, will be deemed allowable in FMS sales.

However, problems have arisen when contractors attempt to price the cost of indirect offsets. While pricing the FMS deal and any direct offsets is a fairly straightforward effort, pricing indirect offset has proven to be a tough challenge because the DoD Contracting Officer lacks the necessary information to determine that the proposed price is fair and reasonable. If the price cannot be determined to be fair and reasonable, then the contractor risks having the indirect offset costs challenged, and disallowed, as being unallowable.

On June 2, 2015, the DAR Council attempted to remedy those problems by **revising** the DFARS via an interim rule – i.e., one promulgated without the benefit of public input. The necessity of issuing an interim rule was explained by the DAR Council as being related to the “recent and foreseeable trend of increasing numbers and complexity of indirect offsets….” According to the rulemakers—

Contracting officers must follow these regulations even though no DoD appropriated funds are being used to pay for the effort, and DoD contracting officers have no insight to pricing of the indirect offset. In the past several years, compliance with regulations has resulted in an inability of contracting officers to finalize FMS contract negotiations.

Accordingly, the interim rule –

… affirms that all offset costs that involve benefits provided by a U.S. defense contractor to an FMS customer that are unrelated to the item being purchased under a Letter of Offer and Acceptance (LOA), *i.e.,* indirect offset costs, are deemed reasonable for purposes of FAR part 31. The rule provides that no additional analysis is necessary on the part of the contracting officer, provided that the U.S. defense contractor submits to the contracting officer a signed offset agreement or other documentation showing that the FMS customer has made the provision of an indirect offset of a certain dollar value a condition of the FMS acquisition. Finally, the rule provides that the FMS customer shall be notified through the LOA that indirect offset costs are deemed reasonable without any further analysis by the contracting officer.

And so one challenge associated with offsets has been solved.