When talking about the FAR cost principles, too many people focus exclusively on the 47 principles dealing with "selected costs" and ignore the seven "general" principles—or those principles that the late Mel Rishe called the "cornerstone principles." The general or cornerstone principles provide overarching guidance that applies to every single contractor that has a contract with the 52.216-7 ("Allowable Cost and Payment") clause. As such, it is arguably more important to understand the general cost principles than it is to understand the principles dealing with selected costs.

This article with address one of the seven general cost principles: FAR 31.201-5 ("Credits"). It is a deceptively simple rule; yet it is one that has gotten many a contractor into trouble.

The cost principle is quite short. It reads (in its entirety) as:

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. See 31.205-6(j)(3) for rules governing refund or credit to the Government associated with pension adjustments and asset reversions.

It's two sentences long, and one of those sentences refers the reader to another cost principle. Basically, then, the "credits" cost principle is a single sentence. Should be easy to comply with, right?

The credits cost principle is tied to the FAR Part 31 definition of "total cost" found at 31.201-1. That cost principle defines the composition of total cost as "the sum of the direct and indirect costs allocable to the contract, incurred or to be incurred, plus any allocable cost of money … less any allocable credits." Notice the slight wording change, i.e., the use of "applicable portion" versus the use of "allocable"—is that a meaningful difference? In practice, no.

In her essential and indispensable book, Government Contract Costs & Pricing, Karen Manos notes that the credits cost principle has been in existence since 1948. The original ASPR language added some details, including this sentence: "Income and other credits arising out of operations under the contract, where the related cost was reimbursed or accepted as an allowable cost, will be credited to the Government." Accordingly, we see that the intent was to create a nexus between income and/or credits received by a contractor and allowable costs. It seems to be the case, then, that income and/or credits related to unallowable costs need not be credited to the government. Indeed, as Ms. Manos notes in her commentary, the ASBCA explained (in MRK-BRJ, ASBCA No. 16031) that "It is not every refund which a contractor may receive to which the Government is entitled. Before any entitlement arises the Government must [first] have paid the costs to which the refund is applicable."

That being said, the credits clause has been applied to state tax refunds received by contractors, to returned vendor items, to annual rebates from travel agencies, to prompt payment and other trade discounts, to receipts from the sale of scrap, to dividends and rebates received under insurance policies, and to many other transactions in which a contractor receives a benefit. In fact, Darrell Oyer, in his book Pricing and Cost Accounting, goes so far as to write that the Credits cost principle "compels contractors to analyze any and all credits received to ascertain their direct or indirect impact on [their] government contracts. … Any credit received needs to be scrutinized to ensure that the government receives its due cost reduction."

Both Manos and Oyer make the point that the requirement to flow-back income and rebates does not end when the contract has been formally closed. The requirement will extend so long as there is a nexus between the credit and the original contract cost. Moreover, the requirement extends to indirect costs as well as to direct costs. Credits received related to claimed indirect costs must be allocated to the government in the same, or in a similar, fashion as the original indirect cost was allocated. This can be difficult to accomplish if the credit shows up a decade or more after the cost was originally incurred. (Think about state taxes and associated tax refunds, for example.)

While the Credits cost principle seems straightforward and simple on its face, in practice compliance with its requirements can present a challenge.

Dealing with Workers' Compensation insurance is particularly tricky. We wrote about the issue **here**. In that article we noted one construction company that was forced to settle a False Claims Act matter related to its expected premium costs used in pricing contract Requests for Equitable Adjustment (REAs).

In **another article** , we discussed the cost principle related to employee relocation reimbursements, and noted that employees who do not fulfill the requirement to stay employed for a year following their relocation trigger a need to credit the relocation cost claimed, regardless of whether the employee pays back their relocation expense to the company.

In our experience, many companies trip over the Credits cost principle requirements. They don't scrutinize their "other income/expense" transactions or they don't "true-up" their Workers' Comp costs accurately, or they do something that seems innocuous until the government shows up to demand its fair share plus interest and penalties. Way back in 1999, we came across a contractor that failed to give the government its fair share of rebates it had received related to providing cafeteria milk to low-income students. That was a multi-million dollar settlement.

The bottom-line is this: if you get something of value related to an allowable direct or indirect government contract cost, you need to give the government its fair share.