In the two previous articles we discussed basic GAAP requirements and some of the fundamental FAR and CAS requirements that may supersede GAAP requirements, especially for government contractors that are subject to Full CAS coverage.

Link to Part 1

Link to Part 2

This article will explore some of the compliance challenges in a government contracting environment. As we hope to demonstrate, sometimes you have to throw out everything you thought you knew in order to comply with the requirements. It can be tough to try to explain what's going on to people who thought they had it all down.

Expensing and Capitalization Revisited

In Parts 1 and 2, we explained that the 205-11 cost principle required contractors subject to Full CAS coverage to comply with the requirements of CAS 404 (to determine the value of the capital asset) and CAS 409 (to determine the estimated service life and the amount of annual depreciation associated with the capital asset). We told you that assets valued at $5,000 or more, which had an estimated service life of two years or more, were required to be capitalized. If the asset was valued at less than $5,000 or had a service life of less than two years, the contractor had some discretion in the expensing/capitalization decision (so long as it consistently followed its written practices). Seems pretty straightforward.

But hold on there.

What about direct contract costs?

Suppose you have a contract that requires a test station to be constructed. The value of the test station is $100,000. It is expected to have a useful life of 5 years. According to what we thought we knew, we are required to capitalize that test station.

But not always. If the test station is a contract requirement, the contractor can charge the entire $100,000 to the contract. The $100,000 will be expensed as costs are incurred.

The same is true for direct material costs. A part that costs $50,000 might well be directly charged to the requiring contract as an expense.

Really.

Don't believe us? Check out CAS 411, which states "The cost of units of a category of material may be allocated directly to a cost objective provided the cost objective was specifically identified at the time of purchase or production of the units."

Check out the cost principle at 31.205-40 (Special Tooling and Special Test Equipment Costs), which states "The cost of special tooling and special test equipment used in performing one or more Government contracts is allowable and shall be allocated to the specific Government contract or contracts for which acquired …"

Thus, it seems apparent that certain transactions are exempted from the standard capitalization criteria. The primary distinguishing characteristic of such transactions is that they are direct contract costs. A contractor may choose to treat those direct contract costs as current period expenses, even if they would otherwise be required to be capitalized.

This is not as much of a free pass as one might think. There are rules regarding when a transaction may be treated as a direct contract cost. For example, see 31.201-4(a) and the definition of "direct cost" at FAR 2.101. In addition, we devoted **an article** to the notion of "authority to acquire," which we broadly defined as "the terms of the prime contract (or higher tier subcontract) gives the entity performing the contract the authority to procure the stuff necessary to execute the contract's (or subcontract's) Statement of Work (SOW)." We noted in that article that contractors who charge goods and services directly to their government contracts without that authority run some risks. We summarized the situation thusly: "… goods and services obtained and direct-charged without the requisite authority to acquire can impact every one of the six DFARS business systems. They can impact financial results. They can impact tax reporting. They can, in extreme cases, lead to disputes and litigation."

So yeah, not really a free pass. But still, valid direct charges will supersede the GAAP and FAR and CAS requirements that we thought we knew.

Direct vs. Indirect Revisited

One of the more interesting questions we encounter, from time to time, is whether a contract requirement *must* be directly charged to the requiring contract. Can you sometimes take a contract requirement and, instead of treating it as a direct contract cost, treat it instead as a capital asset on your balance and recognize the cost ratably over time through depreciation?

Sure you can.

We mean, not always. If you are building a contract deliverable then we're fairly sure that the costs of that deliverable must be charged to the contract, regardless of contract type. But take the example from a couple of paragraphs above, where you have a $50,000 test station you need to build. Assume it's not a deliverable, you simply need it to test widgets and you expect it to last for five years. You are going to test widgets and you may have multiple contracts during that five-year period. As we know, the cost principle at 31.205-40 permits you to direct charge that piece of special test equipment directly to the contract. You can do that. But *must* you do that? The answer—perhaps surprisingly—is *no*. You can, but you don't have to.

First, you and your customer can agree to exclude certain items from contract costs. Looking again at 31.205-40, there's a limitation that states, "Items which the contract schedule specifically excludes, shall be allowable only as depreciation or amortization." Thus, it seems quite clear that the FAR contemplates a contractual agreement that certain items—special test equipment for example—may be excluded from a contract even if otherwise required by that contract; and if that's the case, then the contractor must capitalize and depreciate those items over time, in accordance with its accounting policies and procedures.

And as we noted in the previous article, while depreciation is normally an indirect expense, it does not have to be. CAS 409 expressly permits treatment of depreciation as a direct contract cost, if done consistently and on the basis of usage.

Therefore, it is certainly possible to reduce your estimated (and actual) contract costs on a CLIN or annual basis by proposing to your customer to remove certain items from the contract schedule, such that you will capitalize the costs of those items and amortize the cost over a period of time. You can, if you want, charge the depreciation/amortization as a direct contract expense.

It can be done. Larger contractors do this all the time. (Well, maybe not the direct charge part, but certainly the exclusion part.)

It's not a particularly great financial strategy. If you treat the cost of the item(s) as direct costs of the contract, then you are recovering your costs within a month (assuming a cost-type contract). Even in a fixed-price contract scenario, if you have contract financing payments you are still recovering the vast majority of your costs within a month or two. In contrast, if you capitalize the item(s) and recover them through depreciation/amortization, then your cash flow will be negatively impacted. The costs you would have recovered in roughly 30 days will now be recovered over a period of years. Still, if that's the win strategy then oftentimes a contractor will trade cash flow for the revenue.

A government contractor has some flexibility in its direct versus indirect decision-making, just as it has with respect to its expensing versus capitalization decision-making. Some people (usually auditors) like to argue that if a cost *can be* identified with a final cost objective, then it *must be* allocated to that final cost objective as a direct cost. That is absolutely not the case. The definition of "direct cost" at FAR 2.101 has a subtle nuance that many people miss. Let's quote it—

'Direct cost' means any cost that is identified specifically with a particular final cost objective. Direct costs are not limited to items that are incorporated in the end product as material or labor.

Costs identified specifically with a contract are direct costs of that contract.

See that? A direct cost is one that ***is identified*** specifically with a particular final cost objective—not one that *can be* so identified. If the contractor records a cost as a direct contract cost, then it is one; but if the contractor records the cost as an indirect cost—or as a capital asset—then that cost is not a direct contract cost. Again, consistency is important here, as is transparency and reaching an agreement with a customer regarding contract cost exclusions. We don’t at all mean to say the discretion afforded a contractor with respect to its accounting treatment is a free pass to bid costs one way and account for them in another way.

However, we are confident that the discretion discussed in this article exists, and that it may be used when it makes good business sense to do so.

Expensing versus capitalization. Seems fairly straightforward on first glance. Many contractors can simply follow GAAP and IRS rules, and they’ll be fine. But other contractors have to content with rather complex and nuanced FAR and CAS requirements. Savvy contractors can use those nuances to their competitive advantage.

We trust that you’ve enjoyed the deep dive into the business challenges presented by what seems at first to be a relatively trivial issue.