An accrued expense refers to when a company makes purchases on credit and enters liabilities in its general ledger, acknowledging its obligations to its creditors. In accounting, it is an expense incurred but not yet paid. … An accrued liability represents an expense a business has incurred during a specific period but has yet to be billed for." – The Corporate Finance Institute

It's always been a bit of a pet peeve that GAAP-compliant accrual accounting is insufficient for compliance with government contract cost accounting—primarily the FAR and CAS requirements that drive "allowable" costs. Most companies that have to prepare, submit, and support an audit of their "proposal to establish final billing rates" (popularly but incorrectly called "the incurred cost submission") know this fact.

Adjusting GAAP-compliant general ledger balances to create compliant "claimed costs" and the resulting indirect cost rates is time-consuming and, in general, subject to human error. It would be so much easier (and cheaper) to just submit the year-end balances, let an independent public accounting firm audit them, and then let the government rely on the results! But we don't do that, do we?

Instead, we make adjustments. One of the most common adjustments is to "true-up" year end bonus/incentive compensation accruals to the amounts actually paid. For example, let's assume the company has a 12/31 year-end (calendar and fiscal years match). Let's say that, before the books close for the year on 12/31, the company budgets annual bonus payments at $10,000,000. But the company won't pay that amount to its employees until next February. So it accrues the liability on the books. The company knows that it *will* pay, and the auditors know that the obligation to pay the bonuses is real and the bonuses are related to the current year's results—but the company and the auditors (and the employees) know the bonuses won't be paid for roughly 60 days. It's a legitimate accrual of a known liability.

Because the liability was recorded, an accrued expense entry is also recorded. This is because the accrued expenses related to current period's operations and results. In other words, the famous "matching principle" requires the expense to be matched to the revenue to which it relates. If the expense entry weren't made, then profits for the year would be overstated.

Okay so far? I mean, this is a really simplistic view of things—but I'm trying to get across the important concepts. GAAP requires that the liability to pay bonuses be recognized, and the

recording of the liability triggers the recording of an accrued expense. All based on budgeted (or estimated) values. This is fine. This is normal.

But then government contract accounting says “wait a minute!” The auditors show up and ask how much was *really* paid in February? It’s not exactly $10,000,000! Why not? Well, because several people left the company in January and February, forfeiting their right to collect their bonuses. The company thought it was going to pay the bonuses when it accrued them in December, but it turned out that those particular payments weren’t actually made in February. Let’s say the company paid-out $9,500,000 instead of the $10,000,000 it had accrued. In that case, government auditors expect that the company will “true-up” its claimed expenses by reducing them by $500,000.

What’s good for GAAP isn’t necessarily good for government contract cost accounting.

Shrug. It’s just the way it is. Court after court after court has accepted the notion that GAAP and FAR/CAS don’t always match up. (Though Congress directed that the CAS Board “conform” CAS to GAAP as much as possible … still waiting for any official movement on *that.*) So we accept it and deal with it, and continue to make those adjustments so that GAAP-compliant expense ledgers are now FAR and CAS compliant
claimed
costs.

A **recent case** at the ASBCA caused Judge O’Connell to review the differences between “incurred” and “actual” costs—or, as we would say, between “recorded” and “actual” costs. Because yes, indeed, there is a difference.

Cellular Materials International (CMI) had several cost-type contracts with the Department of Defense (DoD). As required by the Allowable Cost and Payment clause (52.216-7), CMI submitted its proposals to establish final billing rates for its Fiscal Years 2010 through 2014. As Judge O’Connell wrote—

Initially, the Defense Contract Audit Agency (DCAA) informed CMI that its proposals were low risk and would not be audited. But after receiving this notice, CMI revised its 2010-2014 proposals to add $425,000 ($85,000 per year) in general and administrative (G&A) costs for a

consultant, Mr. Haydn Wadley.

(References and citations omitted, as they will be from all direct quotes from the decision.)

Let's start there. CMI submitted its proposals, was told they would not be audited and, upon receiving that notice, decided to add in some more costs. Yeah, like that wasn't going to raise red flag.

What were the additional costs? They were for a consultant. A consultant who just happened to be "CMI's largest shareholder, owning up to about 39% of the shares during this period." Um, *yeah.*
Not suspicious; not at all—right?

Surprising nobody who reads this blog, DCAA auditors questioned the additional costs. All of them. Apparently, another $86,119 of other G&A expenses were questioned as well. (The decision doesn't address them.)

The Contracting Officer issued a final decision, unilaterally establishing the final indirect cost rates at rates that included a disallowance of $511,119.

CMI appealed and, during discovery—

… it produced to the government various documents, including 31 canceled checks, that resulted in the government agreeing that CMI had made $219,583.23 in payments to Mr. Wadley and that these payments were allowable costs. The parties were also able to resolve the portion of the dispute that did not relate to Mr. Wadley, which amounted to an additional $86,119.

Leaving $205,416.57 still in dispute before the Board.

CMI believed that it had supported the majority of the costs still in dispute. To that end—

… CMI has provided the government 27 promissory notes executed each month from October 2012 to December 2014 in which CMI promised to pay Mr. Wadley the amount of $7,083.33, for a total amount of $191,249.91. The notes do not provide for interim payments or contain a date for repayment, other than to state that they are payable five days after demand. As an explanation, Les Gonda, President and Chief Executive Officer of CMI, and Mr. Wadley, in a joint affidavit, state that Mr. Wadley did this 'due to his belief in the future potential of CMI'. Mr. Wadley has not demanded payment … CMI also represented to the government that it issued checks to Mr. Wadley totaling $14,166.66 in December 2011 and September 2012 that remain uncashed.

As noted above, Judge O'Connell had to delve into the meaning of FAR 51.216-7(d). He wrote—

The contractor is required to submit a final indirect cost rate proposal. FAR 52.216-7(d)(2)(i). The rates it proposes 'shall be based on the Contractor's *actual cost experience* for that period.' FAR 52.216-7(d)(2)(ii) (emphasis added). The government contends that 'actual cost experience' is synonymous with 'actually paid' and because CMI has not made any payments on the promissory notes, these costs are not allowable.

FAR 31.0013 provides that 'actual costs means... amounts determined on the basis of costs incurred, as distinguished from forecasted costs...' The FAR does not provide further guidance as to when a cost may be considered to have been incurred and when it is merely forecasted.

The Judge cited several legal decisions. As part of his analysis, Judge O'Connell noted that the Federal Circuit had cited to Black's Law Dictionary. ("The Federal Circuit cited Black's Law Dictionary to define incur as meaning "to suffer 'a liability or expense.'")

Citing to a case involving a petition for damages under the Vaccine Act, Judge O'Connell quoted the following—

[i]n ordinary usage, ... to 'incur' expenses means to pay or become liable for them. In one common usage, a person becomes liable for yet-to-arise expenses at the time of undertaking an obligation to pay those expenses if and when they arise. See Liability, Black's Law Dictionary (10th ed. 2014) (defining liability as the state 'of being legally obligated or accountable,' through civil or criminal penalties).

Judge O'Connell also wrote—

In UMC Electronics Co. v. United States, 43 Fed. Cl. 776 (1999), aff'd 249 F.3d 1337 (Fed. Cir. 2001), the Court of Federal Claims considered the meaning of actual costs in the context of fraud counterclaims filed by the government. In that case, the contractor represented that its claim was based on actual costs. The court found, however, that the claim was based on purchase orders to subcontractors so that it sought, for example, payment for materials that the contractor never received and for which it never received invoices. Relying on the FAR 31.001 definition of 'actual costs' discussed above, the court held that a cost is incurred 'when a person becomes legally bound to pay.' The court recognized that at some future date the contractor might become liable for some of the unbilled costs, but rejected the contention that such a future cost could be considered an actual cost.

These decisions illustrate the fact intensive nature of determining when costs are incurred. Collectively, they demonstrate that a future expense must be more than merely likely or probable to be an incurred cost. …

It is undisputed that more than nine years after execution of the first note, Mr. Wadley has not demanded payment, and that the notes require Mr. Wadley to make a demand before payment is due. Even if the Board were to assume that there is a 'near-certain future prospect' that Mr. Wadley will demand payment, he has refrained from doing so. CMI's liability to pay has not attached because Mr. Wadley has not taken the action necessary to trigger CMI's obligation. Or, to use the Court of Federal Claims' formulation, CMI is not legally bound to pay until Mr. Wadley demands payment. Accordingly, for purposes of FAR 31.001 and 52.216-7(d)(2)(ii), the Board holds that the consulting costs at issue are not incurred costs but are best described as 'forecasted costs.' Thus, the contracting officer correctly determined that these costs are not allowable.

In this case, the Board found that CMI had not incurred costs and it was not permitted to claim those costs as allowable expenses for government contract accounting purposes—even though it had (we assume) accrued them as liabilities on its balance sheet.

Whether or not one agrees with this decision, it is striking that no discussion of accrual accounting requirements under GAAP was made. There was no discussion of the validity of accrual accounting entries with respect to what costs have been “incurred” for government contract accounting purposes.

We noted that CMI was represented by the company’s CEO and not by a law firm well-versed in government contract disputes. Did the choice of representation affect the outcome? We couldn’t say.

However, we will venture the opinion that this case continues the worrisome trend of judges and lawyers trying to parse accounting concepts without the benefit of the opinions of actual accountants in the courtroom. In this case, we think the additional input would have been beneficial to the Board.