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Chapter 8—Selected Areas of Cost

This chapter was designed to provide FAR interpretation guidance only. This chapter is not meant to be authoritative or to supersede the FAR. The entire text of the FAR should be consulted when determining proper accounting treatment (see Appendix D for a listing of resource materials). Specific requirements for State DOTs based on individual State statutes or policies must be separately addressed with the individual DOTs. For use as a quick reference, a listing of common unallowable expenses appears in Section 8.30.

8.1—Background

The purpose of this chapter is to provide guidance for *selected items of cost*, as identified in FAR 31.2. This chapter is organized by FAR 31.2 sub-sections in ascending order, numerically.

As with all costs billed to Government contracts, the selected items of cost discussed in this chapter are allowable only if they are reasonable in amount, allocable to intermediate or final cost objectives, are properly assigned/allocated to appropriate cost objectives, and are not otherwise prohibited by FAR Part 31 and/or related Federal and State laws, regulations, and policies.

Additionally, the deductibility of costs per the Internal Revenue Code (I.R.C.) is not necessarily determinative of their allowability under Government cost-reimbursement type contracts, as there are many types of costs that are deductible for Federal tax purposes but fail to satisfy the allocability, allowability, or reasonableness criteria of FAR Part 31. For example, the I.R.C. allows deductions for advertising; interest; 50 percent of entertainment costs, including alcoholic beverages; and full rental costs of property under common control. By contrast, FAR Part 31 requires these items to be disallowed.

Note: For additional useful guidance, see the FAR Cost Principles Guide, which is published by the Defense Contract Audit Agency: http://www.dcaa.mil/FAR_Cost_Principles_Guide.pdf.

A. Directly-Associated Costs

One of the concepts that must be addressed, per FAR 31.201-6 Accounting for Unallowable Costs, is that costs that are expressly unallowable or mutually agreed to be unallowable, including mutually agreed to be unallowable directly associated costs, shall be identified and excluded from any billing, claim, or proposal applicable to a Government contract. A directly associated cost is any cost that is generated solely as a result of incurring another cost, and that would not have been incurred had the other cost not been incurred. When an unallowable cost is incurred, its directly associated costs are also unallowable.

B. Burden of Proof

Costs must be supported and, per FAR 31.201-2(d), engineering consultants must maintain adequate records, including supporting documentation, to demonstrate that the costs comply with applicable FAR

cost principles. The contracting officer may disallow all or part of a claimed cost that is inadequately supported.

C. Determining Reasonableness

In accordance with FAR 31.201-3, 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. The reasonableness of specific costs must be examined with particular care in connection with firms or their separate divisions that may not be subject to effective competitive restraints. No presumption of reasonableness shall be attached to the incurrence of costs by an engineering consultant. The burden of proof shall be upon the consultant to establish a cost is reasonable.

What is reasonable depends upon a variety of considerations and circumstances, including:

- Whether it is the type of cost generally recognized as ordinary and necessary for the conduct of the engineering consultant's business or the contract performance;
- Generally accepted sound business practices, arm's-length bargaining, and Federal and State laws and regulations;
- The engineering consultant's responsibilities to the Government, other customers, the owners of the business, employees, and the public at large; and
- Any significant deviations from the engineering consultant's established practices.

D. Direct Costs

In accordance with FAR Part 31, a direct cost is a cost attributable to a single final cost objective. The fact that a direct cost is not reimbursed through a contract does not allow the engineering consultant to include the cost in the indirect cost pool. Any direct cost, whether reimbursed or not, is unallowable as part of the indirect cost rate, except as follows: for reasons of practicality, the engineering consultant may treat any direct cost of a minor dollar amount as an indirect cost if the accounting treatment—

- Is consistently applied to all final cost objectives; and
- Produces substantially the same results as treating the cost as a direct cost.

8.2—Advertising and Public Relations

[Reference: FAR 31.205-1]

Per FAR 31.205-1(c), advertising and public relations costs include “. . .the costs of media time and space, purchased services performed by outside organizations, as well as the applicable portion of salaries, travel, and fringe benefits of employees engaged in the functions and activities”

A. Advertising Costs

Selected allowable advertising costs include:

- Employee recruitment, including help-wanted advertising costs in accordance with FAR 31.205-34; and
- Costs of activities to promote sales of products normally sold to the U.S. Government, including trade shows, which contain a significant effort to promote exports from the United States.

Allowable advertising can recruit direct as well as indirect labor. Costs of recruiting employees with skills needed only for commercial contracts are unallowable, however. Costs are considered unallowable when no specific vacancies are to be filled or if the advertising done is out of proportion to the number or importance of the positions to be filled.

B. Trade Show Expenses and Labor

Per FAR 31.205-1(f)(2), unallowable public relations and advertising costs include “[a]ll costs of trade shows and other special events which do not contain a significant effort to promote the export sales of products normally sold to the U.S. Government.”

The unallowable costs specified in FAR 31.205-1(f)(2) pertain to *exhibiting* products and services at trade shows. Accordingly, labor costs for booth attendants, and other associated costs such as booth rental and promotional items, must be disallowed—unless incurred for the export sales purposes described above. By contrast, labor costs generally are allowable for employees who merely attend trade shows for the purpose of training.

C. Public Relations Costs

Public relations include functions and activities dedicated to enhancing an organization's image or products and maintaining or promoting favorable relations with the public.

Specifically, costs of promotional material, motion pictures, videotapes, brochures, handouts, and magazines that are designed to elicit favorable attention to the engineering consultant are unallowable unless used primarily for employee training and orientation. Costs of memberships in civic and community organizations and costs of souvenirs, models, imprinted clothing, buttons and other mementos provided to customers or the public are also unallowable. Costs of sponsoring meetings, symposia, seminars and other special events when the principal purpose of the event is other than the dissemination of technical information are unallowable.

Allowable public relations costs include costs incurred for (a) responding to inquiries on company policies and activities; (b) communicating with the public, press, stockholders, creditors, and customers; and (c) conducting general liaison with news media and Government public relations officers, to the extent that such activities are limited to communication and liaison necessary to keep the public informed on matters of public concern such as notice of contract awards, plant closings or openings, employee layoffs or rehires, and financial information.

D. Bad Debts and Collection Costs

[Reference: FAR 31.205-3]

Bad debts, including actual or estimated losses arising from uncollectible accounts receivable due from customers and other claims, and any directly associated costs such as collection and legal costs are unallowable.

8.3—Compensation

[Reference: FAR 31.201-3, FAR 31.205-6]

Costs must be *reasonable* in amount considering what is normal for a comparable business, the established compensation plan or practice of a given engineering consultant, or restraints imposed by business circumstances. (See FAR 31.201-3 and 31.205-6(b) for more information.) Auditors may challenge either the reasonableness of individual components of employee compensation or the reasonableness of total compensation costs.

For more specifics and details regarding Compensation, see Chapter 7.

8.4—Personal Use of Company Vehicles

[Reference: FAR 31.205-6(m)(2)]

This cost is unallowable, including the portion of cost related to transportation to and from work regardless of whether the cost is reported as taxable income to the employees. Costs associated with luxury vehicles warrant additional attention to ensure costs are reasonable, allowable, and allocable.

8.5—Contributions or Donations

[Reference: FAR 31.205-8]

Contributions or donations, including cash, property, and services, are unallowable except for costs of participation in community service activities such as blood bank drives, charity drives, disaster assistance, and/or similar types of activities.

8.6—Facilities Capital Cost of Money (FCCM)

[Reference: FAR 31.205-10, CAS 414, FAR 15.404-4]

Facilities capital cost of money (FCCM) is an imputed cost related to an engineering consultant's investment in fixed assets/facilities used in contract performance, regardless of whether the source of the investment is equity or borrowed capital. FCCM is billed as a rate, however, FCCM is *not* a form of interest on borrowing. The costs of the capital investment must be determined, measured, and allocated to contracts in accordance with CAS 414.

Engineering consultants are not *required* to propose FCCM in pricing and performing a contract. However, when an engineering consultant chooses to claim cost of money, the estimated FCCM must be specifically identified in the cost proposals relating to the contract under which the cost is to be claimed.

Accounting for FCCM generally occurs through a memorandum entry of the cost. The engineering consultant must maintain, in a manner that permits audit and verification, all relevant schedules, cost data, and other data necessary to support the entry.

On the engineering consultant's indirect cost rate schedule, the FCCM amount must be shown as a separate line item or, alternatively, must be disclosed in the notes. This is necessary to distinguish cost of money from the company's other expenses. This is required because, per FAR 15.404-4, profit/fee does not include amounts applicable to FCCM.

The interest rate used to compute FCCM is the arithmetic mean of the Federal Prompt Payment Act Interest Rate, as determined semiannually by the U.S. Secretary of the Treasury. These rates are published semiannually in the *Federal Register*²³ on or about January 1 and July 1. For a fiscal year ending December 31, the arithmetic mean would be the simple average of the rates for the January 1 through June 30 period and the July 1 through December 31 period.

The average book value of the investment base is multiplied by the cost of money rate. The resulting value is divided by the allocation base units (e.g., direct labor hours or dollars of total cost input) for the corresponding indirect cost pool.

Appendix A to CAS 414 contains the standard form used to compute facilities capital cost of money and includes a detailed example in which the total cost of money on facilities capital is computed on a step-by-step basis.

8.7—Depreciation

[Reference: FAR 31.205-11]

Depreciation of plant, equipment and other capital/fixed assets is allowable if it does not exceed the amount used for financial reporting purposes, is reasonable, and is allocable to assets used in the engineering consultant's primary business activities. Depreciation for financial reporting should be determined using a systematic and rational method of cost recovery based on the useful business life of an asset. Accordingly, depreciation claimed on the indirect cost rate schedule should *not* be based on accelerated cost recovery methods that may be used for IRS tax purposes (e.g., IRC Section 179 write-offs or "bonus depreciation").

When reviewing depreciation expense, special considerations apply to organizations under common control, fully depreciated assets, asset disposals, capital leases, rentals and other special CAS provisions contained in the FAR. Consistency is a key element.

Most of the engineering consultants under contract to State DOTs are not subject to full CAS coverage; therefore, the following would generally apply:

²³ The rates also are available on the Internet. See http://www.treasurydirect.gov/govt/rates/tcir/tcir_opdprmt2.htm.

A. Depreciation Expense Presented Is Same for Both Financial and Income Tax Purposes
 Costs are reasonable if the engineering consultant follows policies and procedures that are: (a) consistent with those followed in the same cost center for business other than Government, and (b) reflected in the engineering consultant's books of accounts and financial statements.

B. Depreciation Expense Presented For Financial Purposes Differs From Income Tax Purposes

Reimbursement of fixed asset costs shall be based on the asset costs amortized over the estimated useful life of the fixed assets using depreciation methods acceptable for financial purposes (e.g., straight line, double-declining balance, or sum-of-the-years'-digits). Allowable depreciation shall not exceed the amounts used for book and statement purposes and shall be determined in a manner consistent with the depreciation policies and procedures followed in the same cost center on non-government business (FAR 31.205-11(c)). In addition, if the amounts used for book and financial statement purposes are not reasonable or equitable, costs should be questioned.

Note: As discussed previously, expenses computed based on special tax deduction methodologies (e.g., I.R.C. Section 179 or "bonus depreciation") are not allowable.

For those engineering consultants that are required to follow CAS, the consultant must comply with the provisions of CAS 409, Depreciation of Tangible Capital Assets, and CAS 404, Capitalization of Tangible Assets. CAS 404 and CAS 409 are incorporated into FAR Part 31. (See Section 8.11 for a discussion of the treatment of gains and losses on sale of assets per FAR 31.205-16.)

8.8—Employee Morale, Health, and Welfare

[Reference: FAR 31.205-13]

Employee welfare and morale expenses incurred on activities to improve working conditions, employer-employee relations, employee morale, and employee performance are allowable. Expenses and income generated by employee welfare and morale activities should comply with FAR 31.205-13.

Although gifts are an expressly unallowable expense, the cost principle specifically excludes two categories of awards from the unallowable gift definition:

- Awards covered by the compensation cost principle FAR 31.205-6; and
- Awards made pursuant to an established plan or policy for recognition of employee achievements.

Note: Employee morale type expenses are often covered by the entertainment cost principle, FAR 31.205-14. FAC 90-31, effective October 1, 1995 clarified that entertainment costs are unallowable under any cost principle, without exception. Consequently, the entertainment cost principle at FAR 31.205-14 overrides all other cost principles.

Recreation expenses are expressly unallowable unless they meet the following criteria:

- The claimed cost is for employee participation in a sports team or employee organization.
- The team or organization is company sponsored.
- The team's or organization's activity is designed to improve company loyalty, team work, or physical fitness.

Taken together, the cost principles at FAR 31.205-13, Employee Morale, and FAR 31.205-14, Entertainment, expressly disallow certain costs that some engineering consultants may have considered allowable prior to the effective date of the current rule, October 1, 1995. Examples of unallowable costs include, but are not limited to:

- Entertainment provided as part of public relations, employee relations, or company celebrations;
- Gifts to the public;
- Gifts to employees which are not for performance or achievement or are not made according to an established plan or policy;
- Travel tickets or tickets to shows or sporting events; and
- Recreational trips, shows, picnics, or parties.

Costs associated with the reimbursement of employee travel expenses are allowable, provided that the employee is in travel status for an official business purpose, the nature of the cost is allowable, and the cost does not exceed the per diem rates established in the Federal Travel Regulation. Reasonableness is considered in nature and amount both for the engineering consultant as a whole and for the employee(s) benefited by the expenditure.

Types of activities that fall under this subsection are very restrictive and limited. Examples of *allowable* activities include in-house publications, health clinics, wellness/fitness, employee counseling services, and food and dormitory services.

8.9—Entertainment

[Reference: FAR 31.205-14]

Costs of amusement, diversions, social activities, and any directly associated costs (such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities) are unallowable. Costs of membership in social, dining, country clubs or other organizations having the same purposes are also unallowable, regardless of whether the cost is reported as taxable income to the employees. Examples of unallowable company sponsored employee social events, include but are not limited to, outings to professional and college sporting events, company picnics, theme and holiday parties, and expo fairs.

8.10—Fines and Penalties

[Reference: FAR 31.205-15]

Costs of fines and penalties resulting from violations of, or noncompliance with, Federal, State, local, or foreign laws and regulations, are unallowable except when incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer.

8.11—Gains and Losses on Depreciable Property

[Reference: FAR 31.205-16]

Gains and losses from the sale, retirement, or other disposition (but see FAR 31.205-19) of depreciable property shall be included in the year in which they occur as credits or charges to the cost grouping(s) in which the depreciation or amortization applicable to those assets was included (but see last paragraph below). However, no gain or loss shall be recognized as a result of the transfer of assets in a business combination (see FAR 31.205-52).

Gains and losses on disposition of tangible capital assets, including those acquired under capital leases (see FAR 31.205-11(h)), shall be considered as adjustments of depreciation costs previously recognized. The gain or loss for each asset disposed of is the difference between the net amount realized, including insurance proceeds from involuntary conversions, and its undepreciated balance. The gain recognized shall be limited to the difference between the acquisition cost (or for assets acquired under a capital lease, the value at which the leased asset is capitalized) of the asset and its undepreciated balance.

Gains and losses on the disposition of depreciable property shall not be recognized as a separate charge or credit when either of the following conditions exists:

- Gains and losses are processed through the depreciation reserve account and reflected in the depreciation allowable under FAR 31.205-11; or
- The property is exchanged as part of the purchase price of a similar item, and the gain or loss is taken into consideration in the depreciation cost basis of the new item.

8.12—Idle Facilities and Idle Capacity Costs

[Reference: FAR 31.205-17]

The term *idle facilities* refers to completely unused facilities that exceed the engineering consultant's current needs. Costs of idle facilities must be excluded from overhead unless:

- The costs are necessary to meet fluctuations in workload, or
- The facilities, when acquired, were necessary but have become idle because of changes in requirements, production economies, reorganization, or other unforeseeable causes. Costs of idle facilities are allowable for a reasonable period, which generally may not exceed one year.

Costs of idle capacity are costs of doing business and are a factor in the normal fluctuations of usage or overhead rates from period to period. Such costs are allowable provided the capacity is necessary or was originally reasonable and is not subject to reduction or elimination by subletting, renting, or sale, in accordance with sound business, economics, or security practices. Widespread idle capacity throughout an entire plant, or among a group of assets having substantially the same function, may be idle facilities.

8.13—Bid and Proposal Costs

[Reference: FAR 31.205-18]

The composition of bid and proposal (B&P) costs is frequently a key issue. Although marketing²⁴ and B&P activities can be similar in nature and frequently are performed by the same employees, there is an important distinction between the activities. That is, basic B&P costs are costs incurred in preparing, submitting, and supporting bids and proposals (whether or not solicited) on potential Government or non-government contracts. By contrast, marketing costs are more general in nature. Therefore, engineering consultants must establish procedures for segregating B&P costs from selling and marketing costs.

B&P costs are allowable and should be treated as indirect costs, unless a specific contract requires submission of a proposal for subsequent work and authorizes the costs to be charged directly to that contract.

8.14—Precontract Costs

[References: FAR 31.205-32 and FAR 31.109(h)]

FAR 31.205-32 provides that (emphasis added):

Precontract costs means costs incurred before the effective date of the contract directly pursuant to the negotiation and in anticipation of the contract award when such incurrence is necessary to comply with the proposed contract delivery schedule. These costs are allowable to the extent that they would have been allowable if incurred after the date of the contract.

Precontract costs are associated with specific contracts and therefore may not be included in the indirect cost pool. Precontract costs that meet the requirements of FAR 31.205-32 may be billable as direct project charges; however, an advance agreement may be required (see FAR 31.109(h)). Precontract labor must remain allocated as a direct cost regardless of whether it is billable to a client.

²⁴ This guide uses the word “marketing” to identify unallowable types of selling, advertising, corporate image enhancement, and market planning costs.

Note: Contracting agencies and engineering consultants should be aware that any project costs incurred prior to Federal authorization of that project, or phase of work within the project, are not eligible for reimbursement from Federal funds.

8.15—Insurance

[Reference: FAR 31.205-19]

A. Insurance on Lives of Key Personnel

Costs of insurance on the lives of key personnel, such as officers, partners, or proprietors are allowable only to the extent that: (1) the insurance represents additional compensation, and (2) the amount paid is reasonable. However, if the company or its owners are beneficiaries, the costs are unallowable.

B. Professional Liability Insurance

Professional liability insurance (also referred to as *errors and omissions insurance*) protects against damages to clients or third parties resulting from professional errors or judgments. The cost of professional liability insurance is allowable, subject to tests of allocability and reasonableness.

Alternately, the costs incurred by an engineering consultant to correct its own defects, settle claims in lieu of correcting its own defects, or similar acts are unallowable costs as either a direct or an indirect charge, however represented. Simply changing the label to “warranty” or “settlement” does not render the costs allowable.

C. Losses and Insurance Deductibles

Per FAR 31.205-19(d)(3), actual losses are unallowable unless expressly provided for in the contract, except :

- (i) Losses incurred under the nominal deductible provisions of purchased insurance, in keeping with sound business practice, are allowable; and
- (ii) Minor losses, such as spoilage, breakage, and disappearance of small hand tools that occur in the ordinary course of business and that are not covered by insurance, are allowable.

D. Self Insurance

Engineering consultants may elect to provide coverage for certain risks from their own resources under a program of self-insurance. The engineering consultant’s decision to self-insure should be based on a determination that the coverage can be provided by self-insurance at a cost not greater than the cost of obtaining equivalent coverage from an insurance company or State fund. If purchased insurance is available, the charge for any self-insurance coverage plus insurance administrative expenses shall not exceed the cost of comparable purchased insurance plus associated insurance administrative expenses.

Generally, engineering consultants will rely on self-insurance to cover ordinary risks and losses and will maintain various forms of purchased insurance to cover major risks and catastrophic losses.

The self-insurance charge plus insurance administration expenses may be equal to, but must not exceed, the sum of comparable purchased insurance plus the associated insurance administration expenses. The engineering consultant’s actual loss experience shall be evaluated regularly and self-insurance charges for subsequent periods shall reflect such experience in a similar manner to purchased insurance.

As discussed in FAR 31.205-19(c)(2), the requirements of FAR 28.308 must be met. This requires self-insurance programs to be submitted for pre-approval when 50 percent or more of the self-insurance costs to be incurred at a segment will be allocated to negotiated Government contracts and the self-insurance costs at the segment are expected to be \$200,000 or more annually.

8.16—Interest Costs

[Reference: FAR 31.205-20]

Interest on borrowings (however represented), bond discounts, costs of financing and refinancing capital (net worth plus long-term liabilities), legal and professional fees paid in connection with preparing prospectuses, and costs of preparing and issuing stock rights are unallowable (but see FAR 31.205-28). However, interest assessed by State or local taxing authorities under the conditions specified in FAR 31.205-41(a)(3) is allowable.

8.17—Lobbying Costs

[Reference: FAR 31.205-22]

Lobbying and political activity costs are generally unallowable. Some examples of these types of costs are activities that attempt to influence the outcomes of Federal, State, or local elections, contribute to political parties or organizations, influence Federal, State, or local legislation, legislative liaison activities or influence employees of the executive branch of government.

Certain activities may be allowable if detailed records are maintained. They may include activities such as providing technical and factual presentation of information through testimony, statements or letters in response to a document request on topics directly related to contracts, or lobbying activities that may directly reduce contract cost.

8.18—Losses on Other Contracts

[Reference: FAR 31.205-23]

Any excess of costs over income under any other contract (including the engineering consultant's contributed portion under cost-sharing contracts) is unallowable. This would include costs applicable to direct project labor and/or expenses not fully reimbursed due to contractual limitations.

8.19—Organization and Reorganization Costs

[References: FAR 31.205-6, FAR 31.205-27]

All costs incurred in connection with planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions or raising capital, are unallowable. However, an exception to this appears in FAR 31.205-27(b); the cost of activities primarily intended to provide compensation (acquiring stock for executive bonuses, employee savings plans, and employee stock ownership plans), are not considered organizational costs, but instead are governed by FAR 31.205-6.

8.20—Patent Costs

[Reference: FAR 31.205-30]

Patent costs not required by the Government contract are unallowable. Certain costs may be allowable if they are incurred as a requirement of a Government contract. They include costs such as preparing disclosures, filing documentation, searching records and counseling related to general patent matters.

8.21—Retainer Agreements

[Reference: FAR 31.205-33]

Work performed by professionals and engineering consultants with special skills are allowable but must be supported by detailed evidence of the nature and scope of the work performed.

Engineering consultants may engage outside professionals and consultants on a retainer-fee basis. FAR

31.205-33(e) requires that allowable retainer fees be supported by evidence that:

- The services covered are necessary and customary,
- The fee is reasonable in comparison with maintaining an in-house capability, and
- The level of past services justifies the amount of the retainer fees.

The supporting evidential matter requirements also apply to retainer agreements, except retainer agreements are not required to (and generally do not) have specific statements of work.

FAR 31.205-33(f) contains three specific documentation requirements that must be met for any professional and consultant service costs including those on retainer-fee basis to be allowable. These requirements are:

- Details of all agreements (e.g., work requirements, rate of compensation, and nature and amount of other expenses if any) and details of actual services performed.
- Invoices or billings submitted by consultants, including sufficient detail as to the time expended and nature of the actual services provided.
- Consultant work products and related documents, such as trip reports indicating persons visited and subjects discussed, minutes of meetings, and collateral memoranda and reports.

8.22—Relocation Costs

[Reference: FAR 31.205-35]

Certain costs of relocating permanent employees are allowable if numerous requirements are met. For more details see FAR 31.205-35(a). Limitations for considering costs allowable include the following criteria, as set forth in FAR 31.205-35(b):

- (1) The move must be for the benefit of the employer.
- (2) Reimbursement must be in accordance with an established policy or practice that is consistently followed by the employer and is designed to motivate employees to relocate promptly and economically.
- (3) The costs must not be otherwise unallowable under [FAR] Subpart 31.2.
- (4) Amounts to be reimbursed shall not exceed the employee's actual expenses, except as provided for in paragraphs (b)(5) and (b)(6) of this subsection.
- (5) For miscellaneous costs of the type discussed in paragraph (a)(5) of this subsection, a lump-sum amount, not to exceed \$5,000, may be allowed in lieu of actual costs.
- (6) Reimbursement on a lump-sum basis may be allowed for any of the following relocation costs when adequately supported by data on the individual elements (e.g., transportation, lodging, and meals) comprising the build-up of the lump-sum amount to be paid based on the circumstances of the particular employee's relocation:
 - (A) Costs of finding a new home, as discussed in paragraph (a)(2) of this subsection.
 - (B) Costs of travel to the new location, as discussed in paragraph (a)(1) of this subsection (but not costs for the transportation of household goods).
 - (C) Costs of temporary lodging, as discussed in paragraph (a)(2) of this subsection.

When reimbursement on a lump-sum basis is used, any adjustments to reflect actual costs are unallowable.

The following types of relocation costs are *unallowable*:

- (1) Loss on the sale of a home.
- (2) Costs incident to acquiring a home in the new location as follows:
 - (i) Real estate brokers' fees and commissions.
 - (ii) Costs of litigation.

- (iii) Real and personal property insurance against damage or loss of property.
- (iv) Mortgage life insurance.
- (v) Owner's title policy insurance when such insurance was not previously carried by the employee on the old residence. (However, the cost of a mortgage title policy is allowable.)
- (vi) Property taxes and operating or maintenance costs.

(3) Continuing mortgage principal payments on a residence being sold.

(4) Costs incident to furnishing equity or nonequity loans to employees or making arrangements with lenders for employees to obtain lower-than-market rate mortgage loans.

Some examples of the conditions which would cause the costs to be unallowable include the following:

- The claimed costs include mortgage-related costs, and the employees were not homeowners prior to the move.
- The move is for a period less than 12 months.
- The move does not benefit the employer.
- The employer does not have a consistent relocation policy for all employees.
- The claimed costs include a loss on the sale of a home.
- The claimed costs represent continuing mortgage principal payments on a sold residence.

8.23—Rent/Lease

[Reference: FAR 31.205-36]

An operating lease is the most common type of agreement used to lease realty or personal property. Under an operating lease, the engineering consultant pays rent to a third party at prevailing market rates. Operating lease payments generally are allowable in full, provided that the leased assets are allocable to, and used in, the engineering consultant's primary business activities. By contrast, special consideration is required for arrangements that are either structured as capital leases (a.k.a. "financing leases") or involve common control.

A. Capital Leases

In some cases, leased property is considered a purchased asset and must be accounted for as a capital lease. Accounting for capital leases requires the property acquired through the lease to be capitalized and amortized/depreciated over the property's useful life. The criteria for classifying leases are discussed in paragraph 7 of FASB Statement No. 13. If a lease meets one or more of the following four criteria, the lease shall be classified as a capital lease; otherwise, it shall be classified as an operating lease:

1. The lease transfers ownership of the property to the lessee by the end of the lease term.
2. The lease contains a bargain purchase option.
3. The lease is equal to 75 percent or more of the estimated economic life of the leased property.
4. The present value at the beginning of the lease term of the minimum lease payment (with certain exclusions) equals or exceeds 90 percent of the fair value of the leased property to the lessor at the inception of the lease over any related investment tax credit retained by the lessor and expected to be realized by him.

B. Common Control and Cost of Ownership

Common control is another important issue when considering the allowability of rental costs. In accordance with FAR 31.205-36(b)(3), charges in the nature of rent for property between any divisions, subsidiaries, or organizations under *common control*, are allowable to the extent that they do not exceed the normal costs of ownership, such as depreciation, taxes, insurance, facilities capital cost of money, and maintenance, provided that no part of such costs shall duplicate any other allowed cost.

Per FASB Statement No. 57—Related Party Disclosures, *common control* is defined as "The possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract or otherwise." The key question is whether a party involved in

the transaction has the ability to exercise control over the operating and financial policies of any related party. An individual does not need to have over 50 percent ownership to have control. The auditor needs to review the transactions that actually occurred to determine whether common control exists. A review of the actual decision-making process and the reasonableness of lease terms are required.

Note: *If any portion of business assets, including square footage of a building, is used for a purpose other than the engineering consultant's business operations, then the associated costs must be excluded from the cost-of-ownership computation. This includes personal use of assets and/or the sublet of office space to another business entity. Costs that can be specifically identified with the sublet space should be disallowed entirely, and a commensurate amount of shared costs (e.g., depreciation and property taxes) should be disallowed based on the relative square footage of the sublet space.*

(For further details, see Section 11.4.G.1, Example 11-8.)

Sale and leaseback rental costs are allowable only up to the amount the engineering consultant would be allowed if the consultant retained title, computed based upon the net book value of the asset on the date the consultant becomes a lessee of the property adjusted for any gain or loss recognized in accordance with FAR 31.205-16(b). The gain or loss is the difference between the net amount realized and the net book value (the undepreciated balance) of the asset on the date of the sale and leaseback transaction. The annual lease cost limitation should reflect the amortization of the adjusted net book value and other costs of ownership which may include facilities capital cost of money, taxes, insurance, and/or similar types of costs.

For personal property (property other than real estate) under common control, rental costs are allowable to the extent that they do not exceed the normal costs of ownership as indicated above unless the same (or similar) property also is rented at the same price to unaffiliated organizations.

8.24—Selling Costs

[Reference: FAR 31.205-38]

Generally. *Selling* is a generic term that includes efforts to market a company's goods and services. Selling costs usually are considered *necessary* for the overall operation of a business, but not all types of selling costs are allowable charges against Government contracts. Costs in the following categories should be reviewed for allowability:

- Advertising (FAR 31.205-1).
- Corporate image enhancement and public relations costs (FAR 31.205-1).
- Bid and Proposal costs (FAR 31.205-18).
- Entertainment costs (FAR 31.205-14).
- Long-range market planning costs (FAR 31.205-12).

Determining Allowability. Selling costs are allowable if they:

- Are reasonable and allocable in accordance with FAR 31.201-3 and FAR 31.201-4, respectively;
- Meet the criteria established in FAR 31.205-1(d) through (f), FAR 31.205-12, and FAR 31.205-18 (as applicable); and
- Are not specifically disallowed by other FAR cost principles (e.g., the FAR 31.205-14 Entertainment cost principle).

Note: *One example of allowable selling costs is direct selling, which involves person-to-person contact to induce a particular customer to purchase the engineering consultant's services.*

Selling and marketing costs cannot be adequately identified by mere reference to account titles. Such a cursory analysis is not sufficient to assess the allocability and allowability of costs within an account. The actual composition of the account or the activities it represents must be known and analyzed.

Allocability. Any selling and marketing costs are subject to Government challenge if the costs can be considered unnecessary/unallocable to Government contracts. In determining the reasonableness of selling costs, the Government considers the nature and amount of the expense in light of the expenses that a prudent individual would incur in a competitive business, the proportionate amounts expended as between Government and commercial business, the trend and comparability of current costs with historical costs, the general level of selling costs in the industry, and the nature and extent of the selling and marketing efforts in relation to the contract value.

General Advertising. Costs of promotional material, brochures, handouts, magazines, or other media designed to call favorable attention to the company and its activities are unallowable. FAR 31.205-38 prohibits claiming these costs as selling expenses since FAR 31.205-1 specifically identifies these costs as unallowable advertising or public relations costs.

8.25—Taxes

[References: FAR 31.201-4, 31.205-20, 31.205-27, and 31.205-41]

Federal income taxes and excess profits taxes are unallowable, as are taxes in connection with financing, refinancing, refunding operations, or reorganizations. State and local taxes are allowable (e.g., property, franchise, income, and use taxes). However, if taxes are paid late or in error, any penalties or interest assessed by the Government (Federal, State, or local) are unallowable.

Engineering consultants that elect Subchapter S Corporation tax status are not taxed at the corporate level; accordingly, no payments or accruals for income taxes should be recorded in the consultant's financial records. S Corporation income passes through to the shareholders and is taxed on their personal income tax returns.

Note: Auditors should ensure that engineering consultants that have elected Subchapter S tax status²⁵ claim only the State or local taxes that are required to be paid by, or are otherwise accrued by, the engineering consultant at the corporate level. The State and local income taxes resulting from the individual shareholders' pass-through income are not allocable to Government contracts and must not be included in the engineering consultant's indirect cost rate.

8.26—Travel Expenses

[Reference: FAR 31.205-46]

A. Generally

Depending on their nature and purpose, travel expenses may be allowable as either indirect or direct contract charges. Travel costs incurred in the normal course of overall administration of the business are allowable and should be treated as indirect costs. Travel costs attributable to specific contract performance are allowable and may be charged to the contract, subject to any special limitations contained in said contract.

Costs for transportation may be based on mileage rates, actual costs incurred, or on a combination thereof. Costs of lodging, meals, and incidental expenses may be based on per diem, actual expenses, or a combination thereof, provided the method used results in a reasonable charge as provided in the Federal Travel Regulation (FTR). In accordance with FAR 31.205-46(a)(2), lodging, meals, and incidental costs must be disallowed to the extent that, on a daily basis, they exceed the FTR per diem rates.

²⁵ The same applies for any other tax status in which taxes on the pass-through income of the corporation must be paid by the individual shareholders (e.g., limited liability companies).

B. Substantiation of Travel Costs

As provided in FAR 31.205-46(a)(7), travel costs shall be allowable only if the following information is documented:

- Date and place of the expenses;
- Purpose of the trip; and
- Name of person on trip and that person's title or relationship to the contractor.

C. Aircraft Costs

Costs of travel in aircraft owned, leased, or chartered by the engineering consultant require additional substantiation and should be subject to additional audit scrutiny. Refer to FAR 31.205-46(c)(1) for additional information.

D. Vehicle Costs

In cases where transportation costs and consultant-owned or -leased vehicles are involved, only the portion of mileage incurred in connection with company business are allowable; accordingly, engineering consultants should maintain mileage logs. Auto lease payments incurred without a documented business purpose do not meet the criteria contained in FAR 31.205-46(d); therefore, these costs are unallowable in full. Related costs such as insurance, gasoline, and car repair also would be unallowable. Extra scrutiny should be applied to costs associated with luxury vehicles.

8.27—Legal Costs

[Reference: FAR 31.205-47]

In the reviewing the allowability of legal costs, the following must be considered:

- Costs incurred in connection with any proceeding brought by a Federal, State, or local government for violation of a law or regulation by the engineering consultant generally are unallowable. (Specific criteria appear in FAR 31.205-47.)
- Costs of legal, accounting, and other related costs that arise as a result of a dispute between engineering consultants that are partners in a joint venture, or similar shared interest arrangement, are unallowable. FAR 31.205-47 also requires for these costs, including directly associated costs, which may be unallowable, to be segregated in the accounting system.
- Legal costs pertaining to organization or reorganization activities are unallowable.
- In certain situations, significant legal costs may be incurred in one or more accounting periods and recoveries from settlements may be received in subsequent periods. A portion of the recoveries should be credited to the accounts where the legal costs were incurred.

Note: In determining whether retainer fees are allowable, see Section 8.21 and the criteria established by FAR 31.205-33.

8.28—Goodwill and Business Combination Costs

[Reference: FAR 31.205-49 and -52]

Generally. A business combination occurs when a corporation and one or more other businesses are combined into a single accounting entity. These combinations are classified as mergers or consolidations and historically were accounted for as purchases or pooling of interests. However, on July 5, 2001, the Financial Accounting Standards Board (FASB) issued Statement 141, which eliminated the pooling of interests accounting method. FASB 141 requires the purchase method of accounting to be used for all business combinations initiated after June 30, 2001.

The Purchase Method and Goodwill. Under the purchase method, a business combination is accounted for as the acquisition of one company by another (a merger). Goodwill may result in these transactions and is computed as the difference between:

- The purchase price of the acquired company (acquiree), and
- The sum of the book values of the acquiree's net assets (total tangible and identifiable intangible assets less liabilities).

Allowability of Business Combination Costs. When the purchase method is used, allowable costs for depreciation and cost of money are limited to the amounts that would have been allowable if the combination had not occurred. Costs for amortization, expensing, or write-down of goodwill (including costs that arise from the impairment²⁶ of goodwill) are unallowable. Engineering consultants must maintain detailed records to identify and track elements of costs for future reporting periods.

8.29—Alcoholic Beverages

[Reference: FAR 31.205-51]

Costs of alcoholic beverages are unallowable, and the engineering consultant's records should clearly segregate these costs, which must be excluded from the indirect cost schedule. Additionally, these costs must be excluded from any direct billings to Government contracts.

8.30—Listing of Common Unallowable Costs

The table on the following page lists expenses that generally are ineligible for cost reimbursement on Government contracts (either as direct or indirect costs). The list is not exhaustive, but it identifies many types of costs commonly incurred by engineering consultants.

²⁶ FASB Statement 142 changed the accounting for goodwill from an amortization approach to an impairment-only approach. Thus, the amortization of goodwill, including goodwill recorded in past business combinations, ceased upon adoption of FASB 142 on January 1, 2002. FAR 31.205-49 has not been updated to recognize this distinction and therefore continues to refer to "amortization."

TABLE 8-1. LISTING OF COMMON UNALLOWABLE COSTS

<u>FAR</u> <u>Reference</u>	<u>Unallowable Costs</u>
31.205-1 and 31.205-38(b)(1)	Advertising
31.205-1(f)(2)	Trade Show Expenses
31.205-1(f)(2)	Trade Show Labor
31.205-1(f)(5)	Brochures and Other Promotional Material
31.205-1(d)(2)	Souvenirs/Imprinted Clothing Provided to Public
31.205-1(f)(7)	Membership in Civic and Community Organizations
31.205-3	Bad Debts
31.205-3	Collection Costs
31.205-6(m)(2)	Personal Use of Company Vehicles
31.205-8 and 31.205-1(e)(3)	Contributions or Donations
31.205-13(b)	Employee Gifts and Recreation
31.205-14	Membership in Social, Dining, and Country Clubs
31.205-14	Social Activities
31.205-15(a)	Fines, Penalties, and Mischarging Costs Related to Violation of Laws
31.205-19(e)(2)(v)	Life Insurance on Key Employees
31.205-19	Costs to Correct Defects in Materials and Workmanship
31.205-20	Interest Expense
31.205-22	Lobbying and Political Activity Costs.
31.205-27	Organization/Reorganization Legal Fees
31.205-27	Organization/Reorganization Accounting Fees
31.205-27	Organization/Reorganization Incorporation Fees
31.205-27	Organization/Reorganization Labor
31.205-27	Capital Raising (Equity or Long-Term Debt) Legal Fees
31.205-27	Capital Raising (Equity or Long-Term Debt) Accounting Fees
31.205-27	Capital Raising (Equity or Long-Term Debt) Lender Fees
31.205-30(c)	Patent Costs
31.205-33(e)	Retainer Agreements (unless properly supported)
31.205-35	Relocation Costs (in certain circumstances)
31.205-46	Travel Costs in Excess of FTR Rates
31.205-49	Goodwill
31.205-51	Alcoholic Beverages