

# Risky Business: Common Compliance Issues with High Risk Clauses of FAR Part 31

*Presented by CohnReznick's Government Contracting Industry Practice*

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*Jeff Witt, CPA, Senior Manager &  
Long Nguyen, CFE, Manager*



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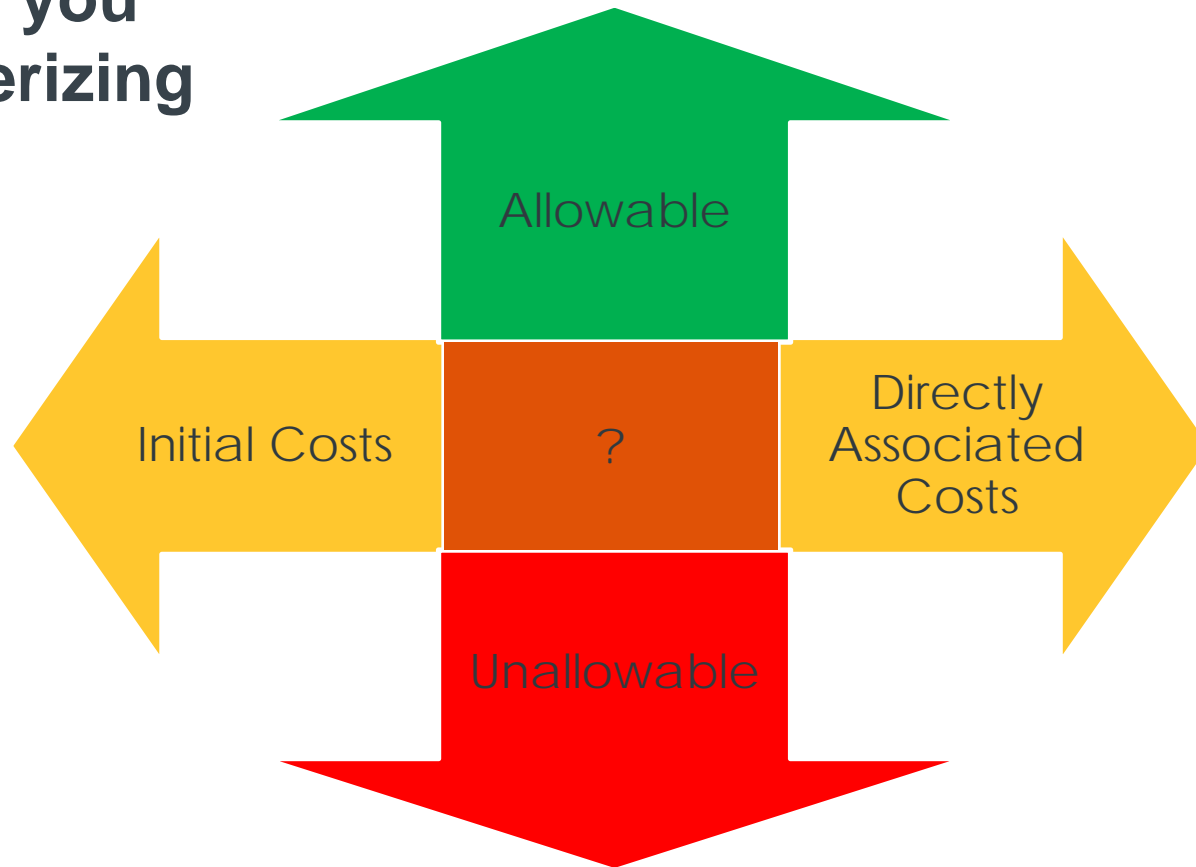
# Risky Business: Common Compliance Issues with High Risk Clauses of FAR Part 31

## Objectives

- ❑ Characterization of Costs and Identifying Allowability
- ❑ Understanding Reasonableness
- ❑ Identifying Issues Allocability
- ❑ Accounting for Unallowable Costs – FAR 31.201-6
- ❑ Gain understanding of Risk of Select Costs:
  - ❑ Travel Costs – FAR 31.205-46
  - ❑ Accounting for Compensation Costs – FAR 31.205-6
    - ❑ Bonuses
    - ❑ Executive Compensation
  - ❑ Professional and Consultant Service Costs – FAR 31.205-33
- ❑ Recent ASBCA Cases Involving FAR Part 31

# Characterizing Costs

How are you characterizing costs?



# CHARACTERIZATION OF COSTS (Continued)

## General Definitions:

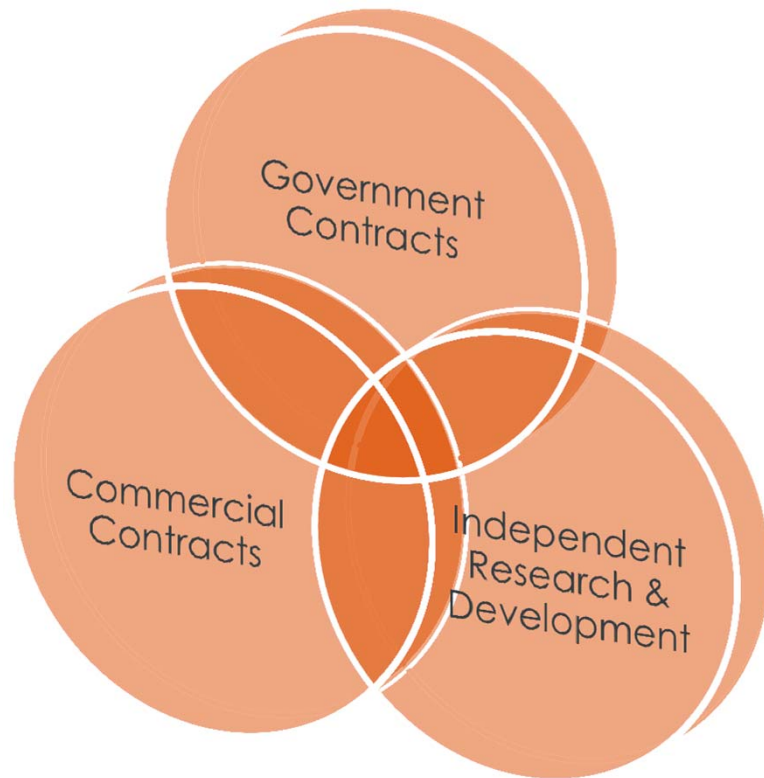
- **Initial Costs**
  - ❑ Costs incurred or expected to be incurred in support of a cost objective.
- **Directly Associated Costs:**
  - ❑ Costs incurred or expected to be incurred as a direct result of an initial cost being incurred.
- **Allowable Costs:**
  - ❑ Costs incurred or expected to be incurred determined to be in compliance with **ALL** applicable FAR Part 31 cost principles.
- **Unallowable Costs:**
  - ❑ Costs incurred or expected to be incurred determined to be in not compliance with **ANY** FAR Part 31 cost principles, contract terms or conditions, or otherwise identified by a contracting officer.

# Determining Allowability Per Federal Acquisition Regulations

*Or in auditing speak determining **Unallowability***

1. Reasonableness
2. Allocability
3. Standards promulgated by the CAS Board, if applicable; otherwise generally accepted accounting principles and practices appropriate to the circumstances
4. Terms of the contract
5. Any limitations set forth in this subpart (FAR Part 31.2) or Agency-specific Supplement
6. Consistency
7. Supporting Records

# Allocability Issues



## Contract Mix

- Single Contract, Single Customer
- Multiple Contracts, Single Customer
- Multiple Contracts, Multiple Customers
- **No Contracts, No Customers**

## Common Issues

- Contract-specific Costs
- Advanced Agreements
- Contract Cost/Rate Ceilings
- Commerciality

# Unallowable Costs Per Cost Accounting Standards

CAS 405-30(a)(4) Unallowable cost means any cost which, under the provisions of any pertinent law, regulation, or contract, cannot be included in prices, cost reimbursements, or settlements under a Government contract to which it is allocable.

**CAS DOES NOT  
DETERMINE ALLOWABILITY!**



# Unallowable Costs Per Cost Accounting Standards (Continued)

CAS outlines 5 different classifications of Unallowable Costs

1. ...expressly unallowable or mutually agreed to be unallowable...
2. ...a written decision furnished by a contracting officer pursuant to contract disputes procedures..
3. ...written decision furnished pursuant to contract disputes procedures designated as unallowable directly associated costs of unallowable costs ...
4. The costs of any work project not contractually authorized, whether or not related to performance of a proposed or existing contract...
5. ...exceeds a limitation-of-cost or ceiling-price provision in a contract...

# Assessing Reasonableness

## 31.201-3 Determining reasonableness.

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.

- Prudent Person Examples:
  - Idle facilities: Would a prudent person act as the company acted to create the idle facilities costs.
  - Employee Morale: While fitness center costs may be allowable per FAR 31.205-13, if the costs are “excessive” then the costs can be questioned based on reasonableness.
  - Travel Costs: Attending training that only has a peripheral relationship to the work the employee is performing could be considered unreasonable. Also, if the location of the training appears unnecessary, the travel can be questioned as unreasonable also.

# Assessing Reasonableness

## 31.201-3 Determining reasonableness.

- Reasonableness, to some degree, is in the eye of the beholder.
- Each auditor may have different perceptions of how to interpret this clause, resulting in different determinations of reasonableness.
- As always, documentation to support your position is key.

# Assessing Reasonableness (continued)

## ORDINARY AND NECESSARY

- Examples areas of risk include:
  - Salaries to executives (even though addressed in other section of FAR Part 31) could be found to be unreasonable.
  - Perks for executives, such as a company owned yacht, would not normally be considered ordinary and necessary.
  - High dollar retainers for retired executive to act as consultants would often not be considered ordinary and necessary.
  - Contracting out of activities that could be performed by in house personnel may be considered unreasonable in certain circumstances.
  - Severance payments when the company was not required to make the payments.
  - Certain legal costs, when considered unusual or unnecessary.

# High Risk FAR Clauses

## Risky FAR Clauses

- FAR 31.201-6 - Accounting for Unallowable Costs
- FAR 31.205-46 - Travel Costs
- FAR 31.205-6 - Compensation for Personal Services
- FAR 31.205-33 - Professional and Consulting Services



## Why are these high compliance risk?

- Subject to multi-FAR references
- Susceptibility to a high degree of human error
- Requires exercise of sound business judgment
- Documentation requirements

# Accounting for Unallowable Costs

## 31.201-6 Accounting for unallowable costs.

Costs that are expressly unallowable, mutually agreed to be unallowable or directly associated costs to unallowable costs must be excluded from claims to the government (but not the allocation bases)

- Expressly unallowable is per FAR Part 31.205 and relevant contract or grant terms
  - Contract terms and agency regulations trump other criteria for allowability. This requires that the auditor become very familiar with the contract terms and agency specific regulations.
  - Recent ASBCA case (ASBCA 57576) indicates that such costs must be identified as unallowable in “direct and unmistakable terms.”
  - When a cost is not expressly unallowable, there can be no penalties pursuant to FAR 42.709.
- Mutually agreed to be unallowable involves agreements with the contracting officer and the contractor

# Accounting for Unallowable Costs (continued)

## 31.201-6 Accounting for unallowable costs (continued)

- Directly associated costs (including labor associated with unallowable activities)
  - Policies, procedures and controls are key in this area.
- Some auditors may not understand the nuances of this regulation and related court cases as they pertain to labor costs.

# Accounting for Unallowable Costs (continued)

## 31.201-6 Accounting for unallowable costs (continued)

- Statistical sampling is an acceptable practice for contractors to follow in accounting for and presenting unallowable costs!
- Some contractors combine a real time control to exclude unallowables but also have an after the fact statistical sampling control to detect any additional unallowables.

Risks related to using sampling:

- Not utilizing a statistically sound technique
- Not sampling from homogeneous populations
- Not documenting sampling performed sufficiently



# Characterization of Travel Costs



What are the types of Travel Costs?

- Airfare
- Lodging
- Car Rental
- Baggage
- Mileage
- Other costs directly associated traveling

# Characterization of Travel Costs (Continued)

## How is Travel permitted?

- The Contiguous United States (CONUS)
  - ❑ Federal Travel Regulations
- Outlying areas of the United States (OCONUS)
  - ❑ Joint Travel Regulations, Volume 2
- Everywhere else (Overseas)
  - ❑ Standardized Regulations (Government Civilians, Foreign Areas), Section 925

## Characterization of Travel Costs (Continued)

The requirements and provisions of the Government travel regulations are to be applied to contractors only in the following three specific areas:

- Definitions of lodging, meals, and incidental expenses. Incidental expenses include fees and tips to waiters and porters; transportation between places of lodging or business and places where meals are
- Maximum per diem rates.
- Special or unusual situations.

## Characterization of Travel Costs (Continued)

Cost Element	Federal Travel Regulations	Joint Travel Regulations	Department of State Standardized Regulations
Lodging Taxes	Separate allowable expense	Separate allowable expense	Included in lodging rate
Laundry/Dry Cleaning	Separate allowable expense	Included in M&IE rate	Included in M&IE rate

FAR 31.205-46 does not incorporate the Government travel regulations in their entirety.

# Characterization of Travel Costs (Continued)



## Key considerations:

Per Diem location - Where are they going?

Airfare Type – How did they get there? Coach, Business/First-class?

Reasonability – Would I really pay this?

Authorizations – Who let me go?

Duration of the trip or frequency – When did this occur?

Documentation – Best value for the type of travel

# Accounting for Compensation Costs

## 31.205-6 Compensation for personal services.

- Bonuses and incentive compensation are allowable provided the—
  - (i) Awards are paid or accrued under an agreement entered into before the services are rendered or pursuant to an established plan or policy followed by the contractor so consistently as to imply, in effect, an agreement to make such payment; and
  - (ii) Basis for the award is supported.
- Compensation (including bonuses) for owners, partners, etc are subject to additional rules regarding distributions of profits

# Accounting for Compensation Costs (Continued)

## 31.205-6 Compensation for personal services (continued)

Bonuses and incentive compensation (continued).

Before the Services are Rendered: We often see instances where the bonus is determined near the end of the year once yearly profitability has been determined. This practice can result in bonuses being considered unallowable. Auditors will likely question bonus costs if they can prove the amount of the bonus (company in total and for specific people) was based on company profitability and that was the only factor in how the bonus was calculated.

# Accounting for Compensation Costs (Continued)

## 31.205-6 Compensation for personal services (continued)

Bonuses and incentive compensation (continued).

Pursuant to an Established Policy: Companies may have a bonus policy, but if the policy indicates significant discretion on the part of management to determine the total bonus pool and the amounts to specific individuals, auditor may question the bonus even though an established policy exists because the policy is allowing management to much discretion to determine bonus amounts after the fact. Companies need to be careful to draft bonus policy wording in such a way as to avoid unallowability determinations. This can be accomplished by creating metrics, which determine the amount of the bonus rather than management discretion.



# Accounting for Compensation Costs (Continued)

## 31.205-6 Compensation for personal services (continued)

Bonuses and incentive compensation (continued).

Basis for Award is Supported: The company should maintain good documentation of how the bonus amount was determined to show auditors that the policy was followed in the calculation of the bonuses (company in total and for specific people). Absent this documentation, auditors can question the bonus costs.

# Accounting for Compensation Costs (Continued)

## 31.205-6 Compensation for personal services (continued)

Bonuses and incentive compensation (continued).

Distribution of Profits: The Lulejian ASBCA case (20094) imposed a 3 part test to determine whether a bonus is actually a distribution of profits:

1. Were dividends declared? (i.e. whether the bonus was actually a disguised dividend).
  2. How large a bonus pool was allocated to top executives (i.e. higher proportions to executives increased likelihood it is a distribution of profits).
  3. How substantial the rest of the bonus recipient compensation was (i.e. if the compensation otherwise substantial, this increased the likelihood it is a distribution of profits).
- This is a complex area and every situation will likely have different fact patterns, so allowability determinations will be difficult

# Accounting for Compensation Costs (Continued)

## 31.205-6 Compensation for personal services (continued)

- Any compensation which is calculated, or valued, based on changes in the price of corporate securities is unallowable.
- To determine amount unallowable:
  - If strike price = current market value on date of award, then any expense recognized is unallowable as it represents the change or expected change in stock price.
  - If strike price is less than current market value, then the calculation is more complicated and some of the expense may be allowable.

# Accounting for Compensation Costs (Continued)

## 31.205-6 Compensation for personal services (continued)

### Executive Compensation (continued)

- FAR 31.205-6(p): Compensation subject to the cap (and to reasonableness considerations) is the total amount of wages, salary, bonuses, deferred compensation..., and employer contributions to defined contribution pension plans...,
- Because different caps apply to different periods of time, contractors may have contracts subject to different caps. As a result, some contractors utilize a “blended cap” approach:
  - DCAA issued MRD 16-PSP-005 (R) and MRD 16-PSP-007(R):
    - Indicated an advance agreement with Contracting Officer is needed for contractors to use this approach.
    - Provide information on how to compute.

# Accounting for Compensation Costs (Continued)

## 31.205-6 Compensation for personal services (continued)

### Executive Compensation (continued)

- Reasonableness: The total compensation for individual employees or job classes of employees must be reasonable for the work performed;
- Some contractors may believe that as long as they are below the cap, they are not at risk. However, reasonableness is also required as part of the clause and the auditor can question any labor for which the contractor does not have data to support reasonableness (i.e. benchmark data or other support).

# Accounting for Compensation Costs (Continued)

## 31.205-6 Compensation for personal services (continued)

- Executive Compensation

Contract Award Date	Applicable Agencies	Covered Employees	31.205-6
Before June 24, 2014	Executive Agencies Other than DoD, NASA, and Coast Guard	Senior Executive	(p)(2)
Before December 31, 2011	DoD, NASA, and Coast Guard	Senior Executive	(p)(2)
On/after December 31, 2011, and before June 24, 2014	DoD, NASA, and Coast Guard	All Employees	(p)(3)
On/after June 24, 2014	All Executive Agencies	All Employees	(p)(4)

# Determining Professional and Consultant Service Costs

## Definition:

- Professional and consultant services: those services rendered by persons who are members of a particular profession or possess a special skill and who are not officers or employees of the contractor.

## Other Key Definitions

- Purchased Labor : Non-employee Labor that is managed closely and supervised on a daily or routine level
- Subcontractor: a seller who enters into a mutually binding legal relationship to furnish the supplies or services (including construction) and the buyer (prime contractor) to pay for them.

## Determining Professional and Consultant Service Costs (Continued)



“...those services acquired by contractors or subcontractors in order to enhance their legal, economic, financial, or technical positions. Professional and consultant services are generally acquired to obtain information, advice, opinions, alternatives, conclusions, recommendations, training, or direct assistance, such as studies, analyses, evaluations, liaison with Government officials, or other forms of representation.



# Special Considerations (Continued)

- Who is managing or supervising the personnel?
- Where are they located?
- Are they providing specialized services?
- Who is in charge of the scope of work?
- How long are they needed?
- Is it cheaper to employ the individual?

# Commonly Unconsidered Risks

- Adequacy of Indirect Rate Structure and reasonableness of Indirect Rates
  - Allocability of costs
  - Identification and assignment of directly associated costs
- Reasonability of base labor
- Small Business Considerations
- Added compliance requirements



# Quick Reference for Allowability

Selected Costs May Be: Allowable (A), Unallowable (UA), or Allowable With Restrictions (AWR)				
Selected Costs	FAR	A	UA	AWR
Alcoholic Beverages	<a href="#">31.205-51</a>		X	
Asset Valuations Resulting from Business Combinations	<a href="#">31.205-52</a>			X
Bad Debts	<a href="#">31.205-3</a>		X	
Bonding Costs	<a href="#">31.205-4</a>	X		
Compensation for Personal Services	<a href="#">31.205-6</a>	X	X	X
Contingencies	<a href="#">31.205-7</a>	X	X	
Contributions or Donations	<a href="#">31.205-8</a>		X	
Cost of Money	<a href="#">31.205-10</a>			X
Deferred Research & Development Costs	<a href="#">31.205-48</a>		X	X
Depreciation	<a href="#">31.205-11</a>			X
Economic Planning Costs	<a href="#">31.205-12</a>	X	X	
Employee Morale, Health, Welfare, Food Service, & Dorm Costs	<a href="#">31.205-13</a>	X		X
Entertainment Costs	<a href="#">31.205-14</a>		X	
Fines, Penalties, & Mischarging Costs	<a href="#">31.205-15</a>		X	X
Gains & Losses on Disposition of Assets	<a href="#">31.205-16</a>			X
Goodwill	<a href="#">31.205-49</a>		X	
Idle Facilities & Idle Capacity Costs	<a href="#">31.205-17</a>		X	X
Independent Research & Development/ Bid & Proposal Costs	<a href="#">31.205-18</a>		X	X
Insurance & Indemnification	<a href="#">31.205-19</a>	X	X	X
Interest & Other Financial Costs	<a href="#">31.205-20</a>		X	X
Labor Relations Costs	<a href="#">31.205-21</a>	X		
Legal & Other Proceedings Costs	<a href="#">31.205-47</a>		X	X
Lobbying and Political Activity Costs	<a href="#">31.205-22</a>		X	
Losses on Other Contracts	<a href="#">31.205-23</a>		X	
Maintenance & Repair Costs	<a href="#">31.205-24</a>	X		
Manufacturing & Production Engineering Costs	<a href="#">31.205-25</a>	X		
Material Costs	<a href="#">31.205-26</a>	X		
Organization Costs	<a href="#">31.205-27</a>		X	
Other Business Expenses	<a href="#">31.205-28</a>	X		
Plant Protection Costs	<a href="#">31.205-29</a>	X		
Patent Costs	<a href="#">31.205-30</a>	X	X	X
Plant Reconversion Costs	<a href="#">31.205-31</a>		X	X
Precontract Costs	<a href="#">31.205-32</a>			X
Professional & Consultant Service Costs	<a href="#">31.205-33</a>	X	X	X
Public Relations & Advertising Costs	<a href="#">31.205-1</a>		X	X
Recruitment Costs	<a href="#">31.205-34</a>	X	X	X

# Quick Reference for Allowability

Selected Costs May Be: Allowable (A), Unallowable (UA), or Allowable With Restrictions (AWR)				
Selected Costs	FAR	A	UA	AWR
Relocation Costs	<a href="#">31.205-35</a>	X	X	X
Rental Costs	<a href="#">31.205-36</a>	X		X
Royalties & Other Costs for Use of Patents	<a href="#">31.205-37</a>			X
Selling Costs	<a href="#">31.205-38</a>	X	X	
Service & Warranty Costs	<a href="#">31.205-39</a>	X		
Special Tooling & Special Test Equipment Costs	<a href="#">31.205-40</a>			X
Taxes	<a href="#">31.205-41</a>	X	X	
Termination Costs	<a href="#">31.205-42</a>	X		X
Trade, Business, Technical, and Professional Activity Costs	<a href="#">31.205-43</a>	X		X
Training & Education Costs	<a href="#">31.205-44</a>	X	X	X
Transportation Costs	<a href="#">31.205-45</a>	X		
Travel Costs	<a href="#">31.205-46</a>			X

# Recent ASBCA Cases Involving FAR Part 31

Case Numbers	Date	Cost Area	Government Position	Board Decision	Relevant FAR
60131	8/29/2016	Building Lease Costs	Exelis, Inc. building should be characterized as capital instead of operating lease and difference between lease payments and depreciation expense are unallowable.	Board dismissed CAS 404 issue but did not dismiss FAR noncompliance issue	FAR 31.205-11 (covers operating leases) and FAR 31.205-36 (capital leases)
59338	2/8/2017	Interorganizational transfers	Interorganizationally transferred material costs were charged to government based on price rather than cost. The government indicated that Project Status Reports showed actual cost and thus, per FAR 31.205-26, ATS was not allowed to claim based on price.	The Board sided with A-T Solutions, indicating that the government did not prove a violation of FAR 31.205-26 because it did not prove that within the accounting system, transfers were at cost.	FAR 31.205-26
57743/57798/58280	4/17/2017	Expressly Unallowable Costs	Numerous issues were involved, including that Raytheon claimed bonus and restricted stock awards should be proportionately withdrawn along with unallowable labor. The governments position was that these were expressly unallowable costs and violated CAS 405, and therefore, penalties and interest should apply.	Most of the appeal was sustained related to penalties and interest. In general, the Board's position was that even if costs were later found to be unallowable, it was not "unreasonable" for Raytheon to believe the costs were allowable. Therefore, penalties and interest did not apply. However, penalties and interest related to lobbying were sustained.	FAR 42.709, FAR 31.201-6

# QUESTIONS/COMMENTS



# RESOURCES

## CohnReznick LLP

8000 Towers Crescent Drive, Suite 1000  
Tysons, VA 22182  
Main: 703-744-6700  
Fax: 703-744-6701

### **Jeff Witt, CPA, Senior Manager**

jeffrey.witt@cohnreznick.com  
(703) 744-6757

### **Long Nguyen, CFE, Manager**

long.nguyen@cohnreznick.com  
(703) 744-6747

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