One of the many barriers that keep commercial companies from becoming government contractors is the requirement to convert their accounting "books" from Generally Accepted Accounting Principles (GAAP) to FAR and CAS-based values. In theory, GAAP and FAR/CAS are closely intertwined but, in reality, there are some treacherous chasms that must be crossed successfully in order to pass government audits; and it is those chasms that create the barriers.

Most companies that successfully cross those chasms do so through gaining knowledge and understanding of the applicable requirements. From the other side of the chasm, most companies understand that FAR Part 31 controls the *allowability* of costs (i.e., whether costs may be priced into cost estimates or included in invoices) whereas CAS controls the measurement, assignment, and allocation of costs. Most companies have learned that, fundamentally, GAAP applies unless a FAR or CAS requirement supersedes a GAAP requirement. FAR and CAS rules *frequently* supersede GAAP rules. Thus, successful government contractors must learn the FAR and CAS rules so that they understand where they apply and supersede GAAP rules, and where they do not apply, such that GAAP accounting is acceptable for use.

FAR 31.201-2(a) provides five tests for cost allowability, and one of them is that a cost must comply with CAS requirements "if applicable;" otherwise, a cost must comply with "generally accepted accounting principles and practices appropriate to the circumstances." But that's not all. It's not that straightforward. For example, contractors that are exempt from CAS are still subject to CAS.

FAR 31.201-2(b) discusses that seeming contradiction. It states—

Certain cost principles in this subpart incorporate the measurement, assignment, and allocability rules of selected CAS and limit the allowability of costs to the amounts determined using the criteria in those selected standards. Only those CAS or portions of standards specifically made applicable by the cost principles in this subpart are mandatory unless the contract is CAS-covered (see Part 30 ). Business units that are not otherwise subject to these standards under a CAS clause are subject to the selected standards only for the purpose of determining allowability of costs on Government contracts. Including the selected standards in the cost principles does not subject the business unit to any other CAS rules and regulations. The applicability of the CAS rules and regulations is determined by the CAS clause, if any, in the contract and the requirements of the standards themselves.

Thus, even contractors who are exempt from CAS (e.g., small businesses) are subject to certain CAS requirements. If they fail to comply with those CAS requirements, the resulting costs may be determined to be unallowable (to the extent they exceed the amount of costs that would have resulted, had the CAS requirements been followed).

Clear? Let's recap:

GAAP controls, unless it doesn't. If there is a FAR Part 31 cost principle that addresses the cost in question, then that FAR cost principle controls. If that FAR cost principle invokes a CAS requirement as a condition of cost allowability, then the CAS requirement controls. Further, if there is any conflict between CAS and FAR requirements (which is a very rare thing), then the CAS requirements trump the FAR requirements.

Companies that have successfully crossed the chasm of converting their GAAP-based financial records to FAR/CAS-based records have learned all that.

But even so, many companies still stumble when trying to address the capitalization versus expensing decision within the government contracting environment. And that's what we want to explore in this series of articles.

Let's start with the basics. An expense is a current period offset, or reduction, of revenue. That's as basic as we can get. You pay a bill, you record an expense associated with that bill payment. You had some cash (which is an asset on your balance sheet); your amount of cash was reduced (which lowered the asset value); and you recorded an expense equal to the amount that your asset (cash) was reduced. (Of course this ignores accruals and pre-paids and a whole lot of stuff, but just go with us here; we are at the most basic level.) When you expense something, you are saying that you have consumed the value of that thing. Moreover, the payment for that thing should reduce—or perhaps offset—your income (revenue) associated with that thing. Your profit is your income less your expenses, so the more expenses you have, the less profit you have. Which can sometimes be a good thing, as many tax accountants will tell you.

On the other hand, when you capitalize something, you reduce your cash balance the same way—because you are still paying for that thing. But instead of creating an expense, you create another asset, such that the value of the asset (basically) equals the amount of cash you just paid. You now have two assets, cash and the capital asset, and the assets on your balance sheet are the same as before you made the payment.

Instead of recognizing the full expense at the time of payment, you recognize an expense ratably over time. That expense is called *depreciation* (or sometimes amortization). You recognize depreciation as the value of the capital asset is reduced over time, through wear and tear. The reason for capitalizing and depreciating an asset is to better match the recognized expense to the revenue associated with it. This is particularly important for purchases of property and equipment, where a company may spend a very large amount up front so that it can generate a stream of revenue over time. Thus, capitalization and depreciation match that expenditure to the stream of revenue; whereas a simple expensing of the expenditure would create an imbalance. At least, that's the theory.

Under GAAP, the decision to capitalize versus expense is often a matter of judgment—and many companies (large and small) do not always make the correct decision. Some companies simply make a mistake that needs to be corrected. But other companies deliberately decide to misstate their books. That's not good.

For example, WorldCom. Remember those guys? WorldCom was once one of the largest phone companies in the USA. Then, in one of the "largest accounting scandals," the company told the SEC and investors that it had made accounting "errors" that had led to its profits being overstated by $3.9 billion. (Some reports say that the company made as much as $11 billion in errors.) According to WordCom's public statements, rental fees for communication lines had been booked as capital expenditures and put on the balance sheet, rather than being properly recorded as current period expenses. Because WorldCom avoided recording expenses, it had inflated its profits.

Here's a link to **an article** on the WorldCom scandal, for those interested. We will quote from it a bit, just to give some perspective.

'The transfer of obvious expenses into capital expenditures is absolutely fraudulent. There's no excuse for this kind of misrepresentation. Almost everyone in the industry would agree that if you're paying a service charge to lease local lines, that's a clear expense,' says Robert A. Howell …. Such expenses must be immediately recognized in the period incurred, unlike expenditures which can legitimately be capitalized as assets and depreciated over their useful life. WorldCom's misrepresentation of these expenses led to an artificial inflation of its net income and EBITDA (earnings before interest, taxes, depreciation and amortization).

In 2005, WorldCom's CEO, Bernie Ebbers, was sentenced to serve 25 years in Federal prison. He is still there today. The WorldCom accounting scandal was one of the drivers that led to passage of the Sarbanes-Oxley Act.

Let's conclude on this thought: the GAAP accounting rules for expensing versus capitalization require judgment, and any mistakes can impact the bottom-line profitability of a company. It's not easy to get it right. For government contractors, the situation is even murkier and it's hard to safely navigate all the FAR and CAS requirements, many of which supersede the GAAP requirements. Even if contractors get the GAAP accounting right, they may well trip over the FAR/CAS accounting requirements, which we will explore in the next article.