In the previous article we discussed basic GAAP requirements and noted that, for government contractors, GAAP applies unless it does not apply. FAR and/or CAS requirements may supersede GAAP requirements; and government contractors are required to comply with the superseding requirements at the risk of having some or all of claimed costs disallowed.

FAR requirements

In addition to the FAR Part 31 requirements we touched-on in Part 1, the FAR has more specific cost principles with which government contractors must comply. Foremost among them is 31.205-11 (Depreciation). That cost principle establishes that "Depreciation on a contractor's plant, equipment, and other capital facilities is an allowable contract cost, subject to the limitations contained in this cost principle." It seems that a contractor can simply comply with GAAP and the resulting depreciation would be 100% allowable. But not so fast.

Before we conclude that compliance with GAAP is sufficient, we have to look at the "limitations" found in the cost principle.

The first limitation is CAS. The cost principle states that contractors that have fully CAS-covered contracts must comply with the requirements of CAS 409 ("Depreciation of Tangible Capital Assets"). If a contractor has a fully CAS-covered contract, then CAS 409 requirements control, not GAAP requirements. However, if a contractor is subject to only modified CAS coverage, or is exempt from CAS coverage, then CAS 409 will not control. In that latter case, "allowable depreciation shall not exceed the amount used for financial accounting purposes, and shall be determined in a manner consistent with the depreciation policies and procedures followed in the same segment on non-Government business." (Except for certain other limitations that we will touch on in a minute.)

The FAR cost principle establishes a hierarchy of compliance requirements. If a contractor is exempt from CAS (or subject only to modified CAS coverage), then it may (generally) follow GAAP with confidence, so long as it does so in a consistent manner. But if a contractor has fully CAS-covered contracts, then it has to follow the requirements of CAS 409 which, to the extent there is any conflict, supersede GAAP for purposes of government contract cost accounting and pricing.

Let’s talk about limitations that might apply to the foregoing general statement.

First, if the contractor acquires assets from the government at no cost then, regardless of the value it puts on those assets for its GAAP accounting purposes, any resulting depreciation is unallowable.

Second, once an asset has reached the end of its service life and has a net book value (NBV) of zero, then no further depreciation is allowed. However, if a government customer wants to use an asset with a zero NBV, then the contractor may charge a “reasonable” rental fee for that use. The cost principle states that “In determining the [value of the] charge, consideration shall be given to cost, total estimated useful life at the time of negotiations, effect of any increased maintenance charges or decreased efficiency due to age, and the amount of depreciation previously charged to Government contracts or subcontracts.”

Third, sale and leaseback arrangement are subject to special cost allowability rules. (See 31.205-11(g)(3) and (h)(1).)

Fourth, capital leases that are amortized over time are covered by this cost principle. Generally, the amortization charges are allowable—but see 31.205-11(h) if you are dealing with capital leases.

Fifth, in business combinations, when the value of purchased assets is changed to fair market value, “the allowable depreciation and cost of money shall be based on the capitalized asset values measured and assigned in accordance with 48 CFR 9904.404-50(d), if allocable, reasonable, and not otherwise unallowable.” For intangible assets, “allowable amortization and cost of money shall be limited to the total of the amounts that would have been allowed had the combination not taken place.”

Other FAR cost principles that are (or may be) relevant to this topic include—

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31.205-10 (Cost of Money)

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31.205-16 (Gains and Losses on Disposition or Impairment of Depreciable Property or Other Capital Assets)

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31.205-26 (Material Costs)

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31.206-36 (Rental Costs)

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31.205-37 (Royalties and Other Costs for Use of Patents)

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31.205-40 (Special Tooling and Special Test Equipment Costs)

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31.205-52 (Asset Valuations Resulting from Business Combinations)

We may come back and visit one or two of the cost principles listed above, but let’s move this along and talk about CAS requirements.

CAS Requirements

As noted above, the depreciation cost principle (31.205-11) expressly invokes the requirements of CAS 409. A government contractor with fully CAS-covered contracts must comply with CAS 409 requirements; if it doesn't then, to the extent the resulting costs exceed those that would have been recorded in accordance with CAS 409, the excess costs are unallowable.

CAS 409 (Depreciation of Tangible Capital Assets) establishes "criteria and guidance for assigning costs of tangible capital assets to cost accounting periods and for allocating such costs in cost objectives within such periods in an objective and consistent manner." The Standard establishes four fundamental rules, as follows—

1.

The depreciable cost of a tangible capital asset shall be its capitalized cost less its estimated residual value.

2.

The estimated service life of a tangible capital asset (or group of assets) shall be used to determine the cost accounting periods to which the depreciable cost will be assigned.

3.

The method of depreciation selected for assigning the depreciable cost of a tangible capital asset (or group of assets) to the cost accounting periods representing its estimated service life shall reflect the pattern of consumption of services over the life of the asset.

4.

The gain or loss which is recognized upon disposition of a tangible capital asset shall be assigned to the cost accounting period in which the disposition occurs.

Those rules establish the capitalization value (how much) and the assignment of resulting depreciation costs to future years (when). The next set of four rules establish how the depreciation expense is to be allocated to cost objectives. They are:

1.

Depreciation cost may be charged directly to cost objectives only if such charges are made on the basis of usage and only if depreciation costs of all like assets used for similar purposes are charged in the same manner.

2.

Where tangible capital assets are part of, or function as, an organizational unit whose costs are charged to other cost objectives based on measurement of the services provided by the organizational unit, the depreciation cost of such assets shall be included as part of the cost of the organizational unit.

3.

Depreciation costs which are not allocated in accordance with paragraph (b) (1) or (2) of this subsection, shall be included in appropriate indirect cost pools.

4.

The gain or loss which is recognized upon disposition of a tangible capital asset, where material in amount, shall be allocated in the same manner as the depreciation cost of the asset has been or would have been allocated for the cost accounting period in which the disposition occurs. Where such gain or loss is not material, the amount may be included in an appropriate indirect cost pool.

In that second set of rules, we see that depreciation expense is normally an indirect expense, unless charged as a direct expense “on the basis of usage and only if depreciation costs of all like assets used for similar purposes are charged in the same manner.” Thus, a government contractor has some flexibility (within strict limits) on how to allocate depreciation expense. In addition to exercising judgment regarding whether to expense or to capitalize, judgment may also have to be exercised regarding whether to charge depreciation as a direct or indirect expense.

Further, CAS 409 recognizes that judgment and estimates are involved in the details. The Standard states “Determination of the appropriate depreciation charges involves estimates both of service life and of the likely pattern of consumption of services in the cost accounting periods included in such life." The Standard provides guidance intended to help the contractor with those estimates.

The Standard also allows use of GAAP treatment in most cases. It states "The method of depreciation used for financial accounting purposes (or other accounting purposes where depreciation is not recorded for financial accounting purposes) shall be used for contract costing unless: (i) Such method does not reasonably reflect the expected consumption of services for the tangible capital asset (or group of assets) to which applied, or (ii) The method is unacceptable for Federal income tax purposes. If the contractors' method of depreciation used for financial accounting purposes (or other accounting purposes as provided above) does not reasonably reflect the expected consumption of services or is unacceptable for Federal income tax purposes, he shall establish a method of depreciation for contract costing which meets these criteria." Thus, at the end of the day, it is very possible that GAAP or IRS-compliant depreciation lives may be acceptable for government cost accounting and pricing purposes.

Looking briefly at CAS 404 (Capitalization of Tangible Assets), we see that CAS establishes firm guidelines regarding the expensing versus capitalization decision. The Standard states that contractors must have a written policy that establishes the decision criteria. Contractors have some flexibility with respect to those criteria; however, "The contractor's policy shall designate a minimum service life criterion, which shall not exceed 2 years, but which may be a shorter period. The policy shall also designate a minimum acquisition cost criterion which shall not exceed $5,000, but which may be a smaller amount." So any contractor subject to CAS 404 must capitalize tangible assets when the purchase price exceeds $5,000 and the estimated service life exceeds two years. The resulting depreciation will generally be allowable if it complies with GAAP and/or IRS regulations. The resulting depreciation is normally an indirect expense; however, in certain circumstances it may be treated as a direct contract cost.

Somewhere within The Beltway, a group of people have been meeting to see if we really need CAS 404 and 409. As noted, in many circumstances GAAP and IRS rules are perfectly fine. Section 820 of the 2017 National Defense Authorization Act (NDAA) required that CAS requirements "be reconciled, to the extent possible, with U.S. Generally Accepted Accounting Principles." See our article on that requirement **here** . Our backchannel tells us that those efforts are not going very well. In particular, we are hearing that the government representatives are not excited to eliminate those two Standards, despite the general agreement that they are not really necessary. As one person stated, "If we can't reach agreement on CAS 409, there is no hope for reaching agreement on anything else." So stay tuned for future articles on that topic.

We have now reviewed the basics. We’ve flown over the GAAP requirements at 50,000 feet and we’ve gone into FAR 31.205-11 in some detail. We’ve reviewed CAS 409 and mentioned CAS 404.

In the next and final article, we’re going to tackle the toughest challenge of all: whether the rules on capitalization and expensing--the rules we've just spent two articles discussing--really work in a government contracting environment.