

# GOVERNMENT CONTRACT COSTS, PRICING & ACCOUNTING REPORT®

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## ¶ 19 Know Your Cost Regulations: The Organization Costs Cost Principle (FAR 31.205-27)

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This article, the third in CP&A Report's "Know Your Cost Regulations" series, focuses on the cost principle for organization costs, Federal Acquisition Regulation 31.205-27 (see below). The article, which has been adapted from a chapter in GOVERNMENT CONTRACT COSTS & PRICING, outlines the cost principle's coverage, describes its history, and concludes with an analysis of the issues that have arisen in connection with its operation.

### 31.205-27—Organization Costs.

(a) Except as provided in paragraph (b) of this subsection, expenditures in connection with

- (1) planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions,
- (2) resisting or planning to resist the reorganization of the corporate structure of a business or a change in the controlling interest in the ownership of a business, and
- (3) raising capital (net worth plus long-term liabilities), are unallowable. Such expenditures include but are not limited to incorporation fees and costs of attorneys, accountants, brokers, promoters and organizers, management consultants and investment counselors, whether or not employees of the contractor. Unallowable "reorganization" costs include the cost of any change in the contractor's financial structure,

excluding administrative costs of short-term borrowings for working capital, resulting in alterations in the rights and interests of security holders, whether or not additional capital is raised.

(b) The cost of activities primarily intended to provide compensation will not be considered organizational costs subject to this subsection, but will be governed by 31.205-6. These activities include acquiring stock for—

- (1) Executive bonuses,
- (2) Employee savings plans, and
- (3) Employee stock ownership plans.

### Overview

The costs of forming or changing the corporate structure of a business and raising capital have been unallowable since T.D. 5000 was published in 1940.<sup>2</sup> The same restrictions are included in FAR 31.205-20, Interest and Other Financial Costs, and ¶ (f)(2) of FAR 31.205-47, Costs Related to Legal and Other Proceedings. The rationale for making such costs unallowable is that they have no relationship to the work of the existing business entity, and therefore provide little benefit to the contractor's Government work.<sup>3</sup>

However, although the costs of planning or executing the organization or reorganization of a business and raising capital are unallowable, recurring costs associated with maintaining the business structure, including costs associated with changes in the ownership of the contractor's securities, are allowable under FAR 31.205-28, Other Business Expenses. In addi-

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tion, the costs of providing the contractor's securities to employees for the primary purpose of compensation are allowable under FAR 31.205-6, Compensation for Personal Services. The costs of long-range management planning, including plans to make an organizational change, are allowable under FAR 31.205-12, Economic Planning Costs, and ¶ (b)(b) of FAR 31.205-38, Selling Costs.

The line between allowable organizational planning activity and unallowable organization costs is a frequent source of disagreement between contractors and Government auditors. In fact, the illustration in Cost Accounting Standard 405-60(c) uses this frequent source of disagreement as an example of the type of cost that need not be identified and excluded from contract costs until the contracting officer determines that it is unallowable.<sup>4</sup>

To resolve this uncertainty, many contractors have adopted policies and internal guidance that draw a clearer line between organizational planning activity and organization costs. For example, many contractors treat generalized long-term planning, which may include consideration of multiple potential targets for a merger, acquisition, strategic investment or teaming agreement, as an allowable organizational planning activity unless they identify a specific, potential target for a merger or acquisition.<sup>5</sup>

### History of the Cost Principle

As originally published on Nov. 2, 1959, Armed Services Procurement Regulation 15-250.23 provided that "Expenditures, such as incorporation fees, attorneys' fees, accountants' fees, brokers' fees, fees to promoters and organizers, in connection with (i) organization or reorganization of a business, or (ii) raising capital, are unallowable."<sup>6</sup> It was revised effective May 1969, to expand the coverage of the first sentence and add a new second sentence, as follows:

Expenditures in connection with (i) *planning or executing* the organization or reorganization in the corporate structure of a business, *including mergers and acquisitions*, or (ii) raising capital, are unallowable. Such expenditures include but are not limited to incorporation fees and costs of attorneys, accountants, brokers, promoters, and organizers, management consultants,

and investment counselors, whether or not employees of the contractor.<sup>7</sup>

In *Boeing Co.*, the Armed Services Board of Contract Appeals held that fees incurred by Boeing in connection with the conversion of its convertible debentures into common stock and a stock split to make its securities more marketable were allowable as other business expenses under ASPR 15-205.24 (now FAR 31.205-28) because the transaction did not raise any new capital and there was no change in Boeing's corporate structure.<sup>8</sup> In response to the *Boeing* decision, the Defense Acquisition Regulation Council in 1977 amended ASPR 15-205.23 to add, after the words "raising capital" in the first sentence, the parenthetical "(net worth plus long-term liabilities)," and to add a new third sentence: "Unallowable 'reorganization' costs include the cost of any change in the contractor's financial structure, excluding administrative costs of short-term borrowings for working capital, resulting in alterations in the rights and interests of security holders whether or not additional capital is raised."<sup>9</sup>

DAR 15-205.23 was next revised effective July 15, 1981 to clarify that the costs of activities designed primarily for the purpose of providing compensation are not organizational costs.<sup>10</sup> DAR 15-205.23 was then carried forward without change to FAR 31.205-27.

FAR 31.205-27 has been amended once since its initial publication. As part of the DAR Council's project on costs arising from mergers, acquisitions and other business combinations, the cost principle was amended effective April 4, 1988 to make unallowable the costs of resisting a corporate takeover.<sup>11</sup>

### Case Law Interpretation

The boards of contract appeals have consistently held that costs incurred in forming a business entity are unallowable.<sup>12</sup> However, in *Navgas, Inc.*, the ASBCA held,

While the expense of incorporation and the legal fees associated therewith would not be allowable under ASPR 15-205.23, the investigation of and effort toward obtaining a favorable classification of the corporation for application of state taxes would appear to be properly allowable, particularly since the effect of such

a successful effort would be a lower service rate to the Government.<sup>13</sup>

In *Dynalectron Corporation*, the ASBCA considered the effect of the May 1969 revision on the allowability of costs incurred in unconsummated acquisitions.<sup>14</sup> The board concluded that such costs were allowable prior to the May 1969 revision, but unallowable under the revised cost principle.

The pre-May 1969 version did not explicitly exclude costs associated with unconsummated acquisitions and it is arguable, considering the ASPR Committee's concern with the subject, that that version did not exclude costs associated with consummated acquisitions either. In any event, we think it is significant that the Committee did not stop with the language that included mergers and acquisitions within the terms "organizations or reorganizations." It went further by including language to disallow expenditures in connection with "planning or executing" the organization or reorganization of the corporate structure. The "legislative history is silent on the reason why the additional change was made but we think the implication is clear: the Committee must have realized that the earlier version of ASPR 15-205.23 did not expressly disallow costs of unconsummated organizations, reorganizations, acquisitions or mergers. . . . In any event, by adding language to ASPR 15-205.23 which disallowed costs in connection with "planning or executing" the organization or reorganization in the corporate structure, including mergers and acquisitions and, also, by revising ASPR 15-205.47 [now FAR 31.205-12] to exclude from its coverage "organizations or reorganizations covered by ASPR 15-205.23," the Committee apparently wanted to make it clear that there was to be no distinction, thereafter, between costs associated with unconsummated or "planned" acquisitions and those associated with consummated or "executed" acquisitions. In our opinion, the pre-May 1969 version of ASPR 15-205.23 did not provide that the costs associated with unconsummated acquisitions were unallowable, but the revision does so provide.<sup>15</sup>

The 1981 revision adding a provision about employee compensation costs effectively codified the result in *General Analysis Corporation*. In that case, the ASBCA held that costs incurred in offering stock options to the contractor's employees were allowable, notwithstanding the fact that the stock offering had the added benefit of raising needed capital.<sup>16</sup> The board stated, "The circumstance that additional working

capital was incidentally obtained by the contractor does not change the fact that the basic purpose was to obtain and hold high-level employees by giving them a personal stake in the company's future."<sup>17</sup>

In *Boeing Co.*, discussed above, the ASBCA observed that there is an "important distinction between capital as net worth plus long term liabilities, the cost of raising which is made unallowable by the regulation, and working capital which this was," and that "the distinction justifies the treatment of these fees as other costs (except interest) of short term borrowings allowable under ASPR 15-201.2, 15-201.3, 15-204 and 15-205.31."<sup>18</sup> Consistently, the ASBCA in *General Dynamics Corp.*, held that although the costs of raising long-term financing are unallowable, the administrative costs incurred in connection with short-term borrowings are allowable, provided they do not constitute costs of financing and refinancing operations proscribed by the interest cost principle now found at FAR 31.205-20.<sup>19</sup>

In *Raytheon Co.*, the ASBCA held that the costs of bonuses and incentive compensation for employees who participate in activities covered by the cost principle are not expressly unallowable because the cost principle does not specifically identify bonuses and incentive compensation and make them unallowable.<sup>20</sup>

#### ENDNOTES:

<sup>2</sup>See T.D. 5000, ¶ 26.9(g)(4) (Aug. 9, 1940) ("Among the items which shall not be included as a part of the cost of performing a contract or subcontract or considered in determining such cost, are the following: . . . legal and accounting fees in connection with reorganizations, security issues, capital stock issues. . . , [and] taxes and expenses on issues and transfers of capital stock"); *Explanation of Principles for Determination of Costs Under Government Contracts*, ¶ 54(p), (q) (Apr. 1942) (including among list of inadmissible costs, (1) "Special legal and accounting fees incurred in connection with reorganizations, security issues, [and] capital stock issues. . ." and (2) "Taxes and expenses on issues and transfers of capital stock and bonds"); Armed Services Procurement Regulation 15-205(l), (r) (1948 Ed.) (listing as examples of unallowable costs, (1) "Legal, accounting and consulting services and related expenses incurred

in connection with organization or reorganization...,” and (2) Taxes and expenses in connection with financing, refinancing, or refunding operations, including the listing of securities on exchanges’); ASPR 15-205.23 (1955 Ed., Rev. 50).

<sup>3</sup>See, e.g., Memorandum from J.W. Ermerins, Chairman, Commercial Cost Principles Committee to Director, Defense Acquisition Regulations Council, “DAR Case 84-18, Accounting for Mergers and Other Business Combinations,” at 6–7 (Feb. 4, 1987) (tracing history of the cost principle) (on file with author).

<sup>4</sup>See 48 C.F.R. § 9904.405-60(c).

<sup>5</sup>See, e.g., Cibinic & Nash, *Cost-Reimbursement Contracting* 878–79 (3d ed. 2004) (“[C]are should be taken to distinguish between the costs of planning an organization change, the costs of which are unallowable, and the costs of generalized long-range planning. Under FAR 31.205-12, Economic Planning Costs, the costs of surveying various business opportunities, making demographic and economic studies, and evaluating potential markets or firms for mergers or acquisitions would be allowable. Conversely, once a target has been identified, the costs of planning or executing organizational changes would be unallowable.”).

<sup>6</sup>ASPR 15-205.23 (1955 Ed., Rev. 50).

<sup>7</sup>ASPR 15-205.23 (1969) (emphasis added).

<sup>8</sup>*Boeing Co.*, ASBCA No. 14370, 73-2 BCA ¶ 10,325. The board rejected the Government’s theory that the costs were unallowable because the contractor would not have incurred them had it not been for the desire to sell more stock, stating that “The ‘but-for’ theory is far too tenuous to support the disallowance of costs which are, strictly speaking, not financing in nature and which otherwise are made expressly allowable, as in ASPR 15-205.24 [now FAR 31.205-28] and 15-205.31 [now FAR 31.205-33].” *Boeing Co.*, AS-

BCA No. 14370, 73-2 BCA ¶ 10,325 at 48,739.

<sup>9</sup>See Defense Procurement Circular No. 76-9 (Aug. 30, 1977).

<sup>10</sup>Defense Acquisition Circular 76-28, 46 Fed. Reg. 50680 (Oct. 14, 1981).

<sup>11</sup>Federal Acquisition Circular 84-35, Item II, 53 Fed. Reg. 10828 (Apr. 1, 1988).

<sup>12</sup>See *Bos’n Towing & Salvage Co.*, ASBCA No. 41357, 92-2 BCA ¶ 24,864 (“We have found that billings by the Pensacola firm of Emmanuel, Sheppard & Condon in the amount of \$ 2,922.05 related to the organization and incorporation of Bos’n as a business entity (finding 38). Such costs are expressly unallowable pursuant to FAR 31.205-27( a) and 31.205-33(d) and must be excluded from the termination settlement.”); *Dynadyne, Inc.*, IBCA-1329-1-80, 81-1 BCA ¶ 15,054 (expenses of the formation of Dynadyne are unallowable under Federal Procurement Regulation 1-15.205-23).

<sup>13</sup>*Navgas, Inc.*, ASBCA No. 9240, 65-1 BCA ¶ 4533.

<sup>14</sup>*Dynalelectron Corp.*, ASBCA No. 20240, 77-2 BCA ¶ 12,835.

<sup>15</sup>Id.

<sup>16</sup>*General Analysis Corp.*, ASBCA No. 6920, 1962 BCA ¶ 3337.

<sup>17</sup>Id.

<sup>18</sup>*Boeing Co.*, ASBCA No. 14370, 73-2 BCA ¶ 10,325.

<sup>19</sup>*General Dynamics Corp.*, ASBCA No. 31359, 92-2 BCA ¶ 24,922.

<sup>20</sup>*Raytheon Co.*, ASBCA Nos. 57576 et al., 15-1 BCA ¶ 36,043; 10 CP&A Rep. ¶ 53.