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# GCA DIGEST

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## Knowing Your Cost Principles...

### NEW INTERPRETATION OF IR&D COSTS

*(Editor's Note. We have been receiving inquiries from subscribers about a recent case – US v. Newport News Shipbuilding – that disallowed Independent Research and Development costs. The case significantly changes the ground rules on when costs can be charged to IR&D and when they must be charged direct to a single contract which has the effect of narrowing the conditions when research and development effort may be allocated indirectly to all of a contractor's work. Now, many of these costs must be allocable to specific contracts whether or not the related costs are recoverable. Before discussing the case, we thought it would be a good idea to present the basics of the cost principle and review some of the legislative history and decisions affecting the issue of when R&D costs may be charged to IR&D and when they need to be charged directly to a cost objective. For the background material on the IR&D cost principle and the legislative/ board history we have relied on an article in the November 2003 Briefing Papers by Karen Manos of Howrey Simon Arnold & White. The discussion of the Newport News case and comments is based upon a private white paper written by a noted law firm for one of our clients. Since we were unable to contact the authors before this publication date, we left the firms name out.)*

#### The Basics of the Cost Principle

FAR 31.205-8, IR&D/B&P costs must be read in conjunction with Cost Accounting Standard 420, "Accounting for independent research and development costs and bid and proposal costs" which is incorporated in its entirety in the FAR cost principle. IR&D and B&P costs will be allocated to final cost objectives in the same manner as G&A expenses for that business unit unless it results in an inequitable allocation. IR&D/B&P costs are generally allowable as indirect costs provided they are otherwise reasonable and allocable. The Armed Services Board of Contract Appeals has consistently rejected government arguments that IR&D/B&P costs are not allocable when incurred in conjunction with commercial work. To qualify as IR&D, the effort (a) must fall within one of the following four categories (1) basic research (2) applied research (3) development or (4) systems and other concept formulation studies and (b) not be "sponsored by a grant or required in the performance of a contract." It is the part (b) above – "sponsored by a grant or required in the performance of a contract" - that is the source of controversy of whether costs must be charged direct to a contract or can be charged indirect to IR&D and it is that feature we will address in this article.

#### The History of the Regulation

The development of the cost principle has had a controversial history in determining when IR&D effort

is "required in the performance of a contract" or "sponsored by a grant or cooperative agreement."

The Armed Services Procurement Regulation 15-205.35 in 1959, which predated the FAR, provided that IR&D "is that research and development which is not sponsored by a contract, grant or other arrangement." The ASPR Council considered changing "not sponsored by" to "not sponsored by or in support of a contract" but industry opposition prevailed when it asserted the change could be interpreted as including IR&D work completely unrelated to a contractor's government contracts. The ASPR was changed in 1971 to state that IR&D "is that technical effort which is not sponsored by, or required in the performance of, a contract or grant."

In 1974, the General Accounting Office attempted to broaden the type of development effort not allowable as IR&D to exclude not only that technical effort *explicitly* required by the terms of the contract but also the effort *implicitly* required to fulfill the contract's objectives. Both industry and the DOD opposed GAO's interpretation where the DOD stated the concept that all work *implicitly* required by a contract should not be allowed as IR&D leaves "a great deal of impreciseness in the definition."

#### Case Law History for "Independent" vs. "Sponsored" or "Required" Effort

In interpreting the term "sponsored" as used in the cost principle, the Armed Services Board of Contract

Appeal (ASBCA) has held that the cost of research projects in excess of contributions from outside sources are allowable as IR&D costs because, at least to that extent, the projects are not “sponsored” by outside sources (*General Dynamics Corp., ASBCA No. 10254*). In that case the Board adopted the contractor’s “common sense” argument that because there was no question the costs were allowable if the contractor had undertaken the research without any financial assistance from outside help, the contractor should not be penalized for obtaining private contributions that effectively reduced the government’s cost.

Cases that construe the term “required by” are not consistent. One case involved costs incurred under a cost-plus-fixed-fee contract where after reaching the funds limitation amount the contractor continued to work, charging the costs to its IR&D account. The government argued the effort was “required” under the terms of the contract and therefore should be an unallowable cost overrun. The ASBCA disagreed holding the costs were properly charged to IR&D because the contractor was not contractually obligated to perform the work (*Unisys Corp., No. 41135*).

In another rather famous case, the contractor was working on a firm fixed price (best efforts) contract to develop two prototypes for the Divisional Air Defense System (DIVAD) where the nature of the contract required the contractor to only provide its “best efforts” to meet the contract requirements and had no obligation to continue work so when it did so it charged its IR&D accounts. Apparently not aware of the difference between a firm fixed price contract and a firm fixed price (best efforts) contract, the government erroneously claimed the contractor mischarged over \$8 million asserting even if the work was not required the costs had to be charged directly to the DIVAD contract because the work could be *specifically identified* with that contract and hence could not be charged to IR&D. The Court disagreed stating the IR&D regulations state work required in the performance of a contract cannot be charged to IR&D but they never use the term “specifically identifiable” nor do they in any way suggest the term has significance with respect to what is and is not IR&D. The Court stated that the proper inquiry into determining whether something should be charged direct to the contract or to IR&D is to determine what is required under the contract’s statement of work (*General Dynamics Corp. v. United States, No. CV89-6726*).

Another case, however, leaves the door open for disallowing IR&D when it is “implicitly required” under the contract. The government alleged the contractor intentionally underbid a contract to design and build a Supersonic Low Altitude Target (SLAT) with the intent of recovering excess costs through IR&D. The contractor argued that the IR&D work, while in support of the SLAT contract, had potential applicability to other future contracts. The Court alluded to the “grey” area of the debate noting that some assert if a task is not explicitly called for in the contract it may be charged to IR&D while the alternative view is that a contract includes everything implicitly necessary to carry it out. Since the parties agreed that the tasks were required by the SLAT it disallowed the IR&D costs leaving undecided whether the “implicitly required” work can qualify as IR&D (*United States ex rel. Mayman v. Martin Marietta Corp. F894 F. Supp. 218*).

### The Newport News Case

This is the first case that squarely addresses the issue of whether work implicitly required by a contract qualifies as IR&D. In the mid-1990s, Newport News Shipbuilding (NNS), a long time government ship building contractor, decided to re-enter the market for construction of commercial oil tankers. It envisioned the creation of two “class” design of tankers, one for the international and one for the domestic market in which the two standard class designs would be modified to suit the requirements of its individual commercial customers. It created two IR&D accounts for the work associated with the two classes and later, when it concluded it could not sell such tankers and abandoned the market, it created a third IR&D account to collect costs that were related to finishing the design work so the design could be preserved in the corporate memory and either be transferred or sold. In 1994 it entered into a contract with a foreign buyer to design and construct four tankers for international use and in 1995, it entered a letter of intent to construct five tankers for domestic use. After receiving opinions from its in-house counsel and Arthur Anderson, it continued to charge its design efforts to the IR&D accounts and charged the contracts only the costs of modifying the “class” design to meet its customers’ requirements.

The total IR&D cost at issue was \$74 million. The government not only disallowed these IR&D costs from its incurred cost proposal claims but The Department of Justice brought a False Claims Act case against NNS in 2003 alleging it charged the tanker

design costs to IR&D when it knew such costs were “required in the performance of a contract” and therefore could not properly be characterized as IR&D costs.

The Court acknowledged that the meaning of “required in the performance of a contract” has been a subject of much controversy and it stated there were three potential interpretations of that language. First, the phrase could be read narrowly, such that only those efforts “explicitly called for in the contract” would be subject to exclusion under the cost principle. Second, the phrase could be read more broadly, to exclude “everything implicitly necessary to carry out” the contract. Finally, the phrase could be read as not focusing on whether the contract requirement was explicit or implicit but rather whether the effort was required by more than one contract. That is, if the effort was required by more than one contract, it could not be said to be required by “a” contract and therefore the cost would be an allowable IR&D expense.

After noting no case law squarely addressed the issue the Court adopted the second interpretation which had the effect of imposing the greatest restriction on IR&D cost allowability. The Court said the costs of efforts “required in the performance of a contract” must be read to include efforts which are not explicitly stated in the contract but are nonetheless necessary to perform the contract and thus implicitly required by it. The Court continued, saying the practical effect of its interpretation is the “required in the performance of a contract” exclusion is to create a temporal dividing line between IR&D and direct work that must be billed to a contract at the point the contract requiring the effort is signed. Prior to such a contract the research and design effort is independent and is eligible to be charged to IR&D provided the effort meets the definition of IR&D. Once a contract is signed, the research and design efforts that are explicitly or implicitly required in the performance of that contract are no longer IR&D. Thus, once a contract is signed the performance of which requires, explicitly or implicitly, a certain effort then that effort may thereafter no longer be charged as IR&D even if it also stands to benefit other existing contracts, potential future contracts or class design.

## Commentary

The white paper authors say though this is only a single decision by a single district court it is the only definitive decision of the issue and hence will likely be relied

upon heavily by DCAA, contracting officers and the Department of Justice. The authors state not only will the “explicitly required” or “multiple contracts” interpretations used by so many contractors change but now contractors who rely on legal interpretations of the IR&D cost principle that are not challenged are subject to False Claims Act liability.

The authors believe the NNS decision adopts a “remarkably simplistic and entirely unworkable timing rule” for application of the IR&D cost principle. The Court’s decision that cost-charging should proceed along a “temporal” path – that is, the effort can be charged to IR&D up to the point a contract is signed and then must be charged to that contract – runs counter to the history and purpose of the IR&D cost principle. It was created so contractors and the government can derive the benefits of contractual R&D and closely-related IR&D efforts and both will suffer if closely related R&D efforts can no longer be pursued in parallel.

As for guidance to contractors, Ms. Manos offers a few suggestions: (1) ensure your employees understand the importance of appropriately characterizing and charging IR&D and B&P efforts (2) before undertaking an IR&D project determine and document your determination that the effort is not required in the performance of a contract or grant (3) when in doubt about the appropriate characterization of certain efforts, consider making a written disclosure of your plan to the cognizant ACO or auditor and if possible, seek an advance agreement and (4) when performing on IR&D projects, ensure there is a mechanism in place for determining whether (and when) you are awarded a contract that requires the same effort.

## ACCOUNTING SOFTWARE FOR GOVERNMENT CONTRACTORS

*(Editor’s Note. In helping clients evaluate various accounting software, we have been happy to see that a few companies are expressly targeting their products to government contractors, providing features that are uniquely oriented to meeting government cost and pricing requirements (e.g. timekeeping, expense reports, incurred cost submittals, billing for cost type work, handling uncompensated overtime, forward pricing, etc.). Recently, we were approached by Wind2 Software, a firm that has been providing accounting software primarily for labor intensive (e.g. professional and non-professional labor services,*

construction firms) as opposed to manufacturing companies. They have recently developed a new accounting package that is explicitly oriented to meeting government accounting requirements and they asked our firm to evaluate how well their software meets these needs. Since they have spent a lot of time considering the needs of government contractors, we asked them to prepare an article for us that would highlight those aspects of accounting software that accounting and finance personnel at firms doing business with the government would (or should) be considering. Though the GCA REPORT and DIGEST does not endorse products we would recommend that government contractors who are considering various systems take a look at their accounting software. You can contact Wind2 at 800 779-4632 or look at their website at <http://www.wind2.com>.)

All accounting software should be evaluated according to its ability to accumulate and report accounting data that is consistent with generally accepted accounting principles, federal and state tax requirements and good project accounting (e.g. budgets, cost, staff utilization, profitability data). In addition firms that are seeking government business need additional features. The contract accounting needs of firms working for the federal, state and local government are unique. Not only must project labor and direct expense be meticulously captured and reported at the cost objective level, but indirect expenses, which forms the foundation of allowable overhead charges on government work, must be aggregated in accordance with Federal Acquisition Regulations (FAR), certain Cost Accounting Standards (CAS), a variety of agency requirements, special contract requirements and DCAA guidelines. And that's just for federal contracts – unique local and state cost accounting requirements are beginning to proliferate. Finally, just to verify that you are doing it all correctly, the system must provide a rock-solid foundation for the scrutiny of government audits and checks that may be performed throughout the life of each contract.

It is no easy matter for a government contract accounting system to meet all of these objectives and there are only a handful of specialized software systems that do. To help you make an informed decision when you purchase your first or next contract accounting system, this article presents the most notable attributes a system should provide.

## Vendor Service

The software vendor-customer relationship is a long term partnership. Be certain the vendor is committed to the success of that partnership. Do they specialize in serving the needs of the professional services firm

and do they have a long track record of doing so? How large is their customer base? Will the vendor demonstrate their product in person and is the staff you interact with knowledgeable of your industry and government contract requirements? Check to see if the vendor maintains user groups in the area and if possible attend a meeting in advance of your purchase. And finally, and perhaps most important, how responsive is the vendor to your calls and requests during the evaluation period? Any lack of responsiveness at this time is a major cause for concern.

*Support and Training.* The success of your implementation and on-going use of the system will be integrally tied to the training and technical support resources provided by the vendor. Are the training services provided locally or must trainers be flown in at great expense? How much training does the vendor estimate for a successful implementation? What kind of on-going training opportunities (e.g. classroom seminars) are available and where are they located? What is the turnaround on calls placed with the support center? Does the vendor offer a self service support web site available 24/7 and how useful is the web site? Be certain the vendor can use the internet to tap directly into your application for web based problem solving. Check out the User Guides, which should be well organized, expertly written, and comprehensive with their contents available in the help system.

*Maintenance.* Software applications that serve the government contractor must evolve in response to changes in technology, government requirements and customer needs/preferences and program errors. The vendor must demonstrate prudent and timely response to all of these factors. They should offer a maintenance program with regularly scheduled updates. They should also have a track-record of seeking customer input regarding product enhancements and responding to that input in a responsible and timely manner.

*Conversion.* You probably have a lot of data in your current accounting system and it could be a real time saver to convert this data to your new system. The vendor should offer conversion services, with a variety of options regarding the type of data that will be converted.

## Technical Features

The application should be Windows-based and compatible with the most recent versions of Windows

2000 and XP. Additionally, certain components of the system, like time and expense entry and report distribution, must be internet accessible using a web browser and standard dial up connection. Be cautious of the application that allows internet access to all of the system's features, particularly sensitive accounting data. Security is a significant concern with this type of application. DOS is dead, so don't even consider any DOS system, nor should you consider any aged DOS system that has simply been dressed up with a Windows interface. Finally, be certain that sensitive financial data is stored and managed in a database like Microsoft SQL. It offers numerous security and performance advantages over older file server-based systems.

### **System Features Specific to the Government Contractor**

Basically, the government wants to be assured that the direct and indirect costs a contractor bills the government are timely, accurate, and complete. In making this determination, the government (primarily its auditors) looks at a variety of factors including how a contractor enters direct costs, computes indirect cost, accumulates costs by cost objectives, ensures that costs are accurate and reconcile to other reports, prepares accurate billings and other reports that show incurred costs, generates and monitors indirect rates and screens unallowable costs. The system you choose must help the controller establish the proper accounting practices and generate required audit information as simply as possible.

Specific compliance-related features to look for in a government accounting system are presented in the following subsections.

#### **◆ Tracking Costs by Cost Objective**

Since the government requires accumulation and reporting of costs by multiple cost objectives – contract, task order, delivery order, out-of-scope work, terminations – the system needs to provide flexibility in segregating the cost information for all conceivable cost objectives.

#### **◆ Time Keeping**

Since labor is the major component of most contracts, the government has developed extensive requirements on what constitutes adequate timekeeping. To meet these requirements the system should:

1. Prevent changes from being made after the timesheet is submitted.

2. Limit changes only to employees, preventing others from changing records without the employee's approval.
3. Maintain a log of all time record changes that includes who made the change when and for what purpose. Ensure the log is active even before posting.
4. Provide multiple approval levels (e.g., immediate supervisor, project supervisor, and program manager).
5. Provide security features and flexibility in who can and cannot access time records.
6. Allow electronic time recording from multiple locations such as corporate, branch offices and the field.
7. Allow electronic time entry by non-employees (e.g., subcontractors) and provide flexibility allowing non-employees to make charges as direct employees or ODCs without processing their time through payroll.
8. Assure that only approved cost objectives are charged.
9. Provide for time in/time out recording at various time intervals.

#### **◆ Labor Charging Controls**

The charging of direct labor attracts the greatest audit scrutiny and government auditors closely monitor how well contractors maintain a variety of "labor distribution" reports. The system you choose must accurately capture and report labor costs, provide reports that identify hours to be assigned to contracts, demonstrate that labor time entered via timekeeping is consistent with labor hours and costs that are assigned to contract cost reports and the system can demonstrate a consistent and accurate flow of information between timekeeping, job costs, the general ledger, subsidiary ledgers and financial statements.

Ask the vendor to demonstrate a short "mock audit" that traces a sample of employees' labor hours and costs from timekeeping, reports that reconcile timekeeping data and job cost records and trace job cost records to the general ledger, to the profit and loss statement and to a variety of standard reports that meet the labor charging requirements of the government.

The system should also provide contractors the ability to handle uncompensated overtime in accordance

with the government's acceptable methods of accounting for it. For example, effective rates by payroll period should be computed and charged to contracts if the contractor chooses to follow that methodology.

### ◆ Expense and Travel Reporting

Tracking employee expenses is also an important area for audit scrutiny with the objective of verifying that direct and associated indirect costs do not include unallowable costs. The system must allow expenses to be recorded in a manner consistent with IRS requirements, including the specification of destination, purpose of trip, travel companions, etc. The system should provide expense and travel reporting controls similar to those in timekeeping (e.g. limit access, log changes, provide for approvals). It should provide clear visibility of allowable and unallowable expenses so unallowable costs can be screened and charged to appropriate accounts but so employees can be reimbursed for all their expenses.

### ◆ Identification of Indirect Labor and Cost Pools

The system should provide multiple setup options so indirect labor can be assigned to departments, cost centers, central service, service centers, and distinct projects (e.g. IR&D, B&P) as well as relevant indirect cost pools. The timekeeping feature must allow time tracking for each indirect cost category.

The system should accommodate the set up of an unlimited number of primary and intermediate cost pools for calculating indirect expense rates. It should be easy to enter adjustments to a cost pool (for example, to identify then exclude unallowable expenses) or to selected/all cost pools in one or multiple fiscal reporting periods. There should be a variety of methods available to adjust cost pools including constants, formulas, or general ledger account balances to also screen for unallowable costs. Finally, for each cost pool the system should provide a supporting schedule for use in Incurred Cost Proposal submittals.

### ◆ Indirect Rates

The system should let you assign labor costs to desired indirect cost groupings and accumulate non-labor costs into these groupings. The system should end the need to maintaining separate spreadsheet models that require tedious importation of cost and, instead, provide for automatic generation of indirect cost data

and computation of indirect rates. Cost pools and bases must tie to general ledger balances. It should let you distribute totals of one pool to other pools, as well as distribute certain accounts to other pools. Once costs of both the pool and base are accumulated, the system should compute indirect cost rates. It must let contractors compute indirect cost rates in accordance with each company's established practices and compute final indirect cost rates for closing out contracts and preparing incurred cost submittals.

The system should maintain an unlimited number of indirect cost rates and allow the associated bases to be established using general ledger accounts, allocations of one pool or individual/grouped accounts made to others, or year-to-date computations. It should generate numerous reports, incurred cost proposal schedules, and identify and adjust unallowable costs.

### ◆ Cost of Money

Though interest costs are unallowable, you can bill the government for the cost of money following the Facilities Capital Cost of Money guidelines. The system you choose should automatically calculate the FCCOM at any cost center level in which the assets belong and provide accurate reporting such as the Facilities Capital Cost of Money Factors Computation report.

### ◆ Actual and Provisional Rates

It should be easy to assign provisional rates to project charges as a percentage, per unit, or fixed amount. If the provisional rates change during the life of the contract, the system should allow you to track the starting and ending date or effective period for each rate. It should provide a comparison of the indirect expense rate to the provisional rate for reporting and analysis. The government's requirement to monitor indirect rates throughout the year should be met by providing a standard worksheet that allows for automatic substitution of budget data with month ending actual data so annualized indirect rates can be computed. And finally, the application should automatically create a work in process transaction to record the difference between the actual and the provisional rate.

### ◆ Project-Level Reporting

In addition to just good project profitability analyses, the government may impose a variety of project data requirements on specific contracts or task orders so

the system needs to generate a multitude of project data reports. Estimate-to-complete computations, actual versus budget analyses on costs and time, project status, employee management and even project profitability reports should be easily accessible. You should be able to customize these reports or create new reports from scratch. In addition, the system should be able to automatically generate required data (e.g. percentage of subcontract dollars to small disadvantaged businesses, training requirements met, etc.)

### ◆ Billing

The system must accommodate a variety of contract types including Cost Type, Time and Material and Labor Dollar, Fixed Price, Fixed Unit Price and Other Transactions. For cost type contracts, for example, the system's billing features should allow you to obtain cost data on all relevant cost objectives (e.g. contracts, task and delivery orders, subtasks, in-kind contributions) and establish "rate on rate" practices where preset indirect cost rates can be applied to multiple costs. It should provide numerous pre-billing reports for control purposes where current and total accumulated costs are identified, provide the ability to establish different indirect billing rates for different cost objectives (e.g. ceiling rates, desirable rates, etc.), provide the ability to change indirect billing rates when it appears that provisional indirect cost rates need to be modified and prevent billings that exceed authorized amounts or funding levels.

The system should provide billing formats that meet regulatory requirements (e.g. DD250, SF 1034 and 1035). Though it is impractical to expect a system to produce proforma formats for every conceivable billing circumstance, the system should provide proforma billings for cost type and T&M contracts that are sufficient for meeting most needs.

### ◆ Screening unallowable costs

Though often insignificant in dollar amount, government agencies want contractors to adequately screen unallowable costs. The system you choose must help you identify unallowable costs at the time an expense is entered, assign it to the correct GL account, and then exclude it from billings, incurred cost submittals, forward pricing rates, etc.

The system should allow the set up of unallowable accounts to aggregate unallowable costs from timekeeping and expense forms, provide ready access

to lists of all transactions in an account for scrubbing purposes and provide for percentage adjustments to specific accounts to eliminate only a portion of costs included in an account.

### ◆ Incurred Cost Submissions

With the right system you should not have to prepare incurred cost proposals and submissions manually or using an offline spreadsheet. The system should automate this arduous, time consuming task.

## Classic Oldie...

### ACCOUNTING FOR CONTRACT LABOR

*(Editor's Note. An article we wrote in the last issue of the GCA REPORT addressed the issue of when purchased labor can be treated as employees versus other direct costs and we received numerous responses including questions on how to treat purchased labor as employees for billing purposes. Since use of purchased labor, rather than permanent employees, is becoming more prevalent, we decided to update and reproduce an earlier article addressing this issue. There are several acceptable ways to account for contract labor for costing and pricing purposes and each should be considered in the light of your pricing objectives.)*

The use of contract labor has definitely increased over the last few years and is likely to continue. There are numerous way of accounting for contract labor that work at the contractor's workplace:

### ◆ Direct Costing as an ODC

The most common way of accounting for this labor when the dollars are insignificant is to allocate the costs to "other direct costs" when the work is for a contract or as "indirect cost" when the work is for an indirect function. However, when these costs are significant, the direct costing allocation may be inappropriate. For example, if half the workforce at a contractor's facility is contract labor while the other half are employees and all individuals work at the same place, then the normal practice of allocating overhead only on employees may greatly alter cost allocations to specific contracts when the ratio of purchased labor to employees is not uniform. The failure to allocate the workplace costs to both contractor employees and non-employees may be considered inequitable by the government.

## ◆ Other Costing Methods

One solution for such inequitable cost allocations would be to include the cost of contract labor in the direct labor cost allocation base for overhead. For pricing purposes, when average direct labor rates are used, the cost of contract labor would have to be included with contractor employee costs to determine an average rate. This has the result of increasing direct rates and lowering overhead (because of the high denominator number).

Commonly, burdened contract labor rates per hour are greater than employee rates especially when a company is providing the purchase labor because they may be paying limited fringe benefits and are including a markup. If the entire amount was a direct charge and then indirect costs applied, it would be inequitable for the following reasons: (1) fringe benefits for employees would be allocated to direct labor which includes employees and contract labor which, in turn, already may include fringe benefits and markup (2) contract labor charges may be excessive if they include two fringe benefits allocations (e.g. one from the subcontracting company and one from the contractor) and (3) the markup would be charged only to that contract(s) where the contract labor is used and not to others.

When the rate difference is substantial, other cost accounting techniques may be necessary. One method would be to segregate the invoice from the company (or from the individual consultant or contract employee) into a direct labor cost portion and an overhead portion. The justification for this treatment is that the invoice is comparable to the direct charge plus some overhead of contractor employees. The segregation of costs can be accomplished in three ways:

1. Segregate the direct labor cost portion based on the direct labor rate of a comparable employee and allocate the remainder of the cost to overhead.
2. Segregate the direct labor cost portion based on invoice information from the provider.
3. Prorate the invoice to direct labor and overhead based on the ratio of direct labor to overhead experienced by the contractor.

Though Option 1 is the most common method, the concept underlying all three has been validated by an Armed Service Board of Contract Appeal decision (*Software Research Associates, ASBCA 88-3 BCA*). In the case, the contractor entered into a time and materials contract where all-inclusive fixed rates for

various labor categories were established. During contract performance, the contractor used contract employees and billed at the rate established for direct labor categories. The government argued this labor could not be billed as direct labor because the labor was performed by non-employees resulting in an unfair windfall for the contractor. Rather the contract labor should be invoiced as an “other direct cost” or as “material” of the T&M contract.

The Board disagreed because the work performed by the contract employees was indistinguishable from that provided by contractor employees. The government’s windfall argument was insufficient to overcome this fact and the Board concluded one of the three methods (or a similar alternative) identified above would be acceptable provided the method used was consistent with the way it booked charges for government reporting purposes.

## DCAA Guidance

The Defense Contract Audit Agency has a section in its Contract Audit Manual on Purchased Labor in Chapter 7-2102. Unless purchased labor is used to meet temporary or emergency requirements, auditors are told to “carefully study” the contractor’s practice to determine whether additional costs are reasonable, necessary and properly allocated to government contracts.

Initially auditors are told to (1) review any written policies on treatment of purchased labor and analyze the practices of treating purchased labor in the current and most recently completed fiscal year (2) determine the number of purchased labor (3) ascertain their duration of engagement (4) compare number of employees in each relevant classification to purchased labor (5) compare the cost per staff-year with contractor’s comparable personnel (6) evaluate the reasons for using purchased labor especially for periods exceeding one year which should include technical input if needed and (7) determine the extent of purchased versus employee labor on government versus commercial work and on cost type versus fixed price government work and determine whether there is an “equitable” allocation of costs.

The guidance notes that contractors may treat purchased labor as either other direct costs (e.g. subcontractors) or as direct labor with the excess over employee labor charged to overhead. In determining whether the allocation of costs are “equitable” the guidance states auditors should follow the



fundamental requirements of CAS 418 that states pooled costs should be allocated to cost objectives in a reasonable proportion to the causal or beneficial relationship of the pooled costs to cost objectives. Purchased labor should share in an allocation of indirect expenses when there is such a causal beneficial relationship and the practice should be consistent with the contractor's disclosed or normal practices. The guidance states sometimes a separate allocation base may be necessary to allocate significant overhead costs to purchased labor such as supervision and occupancy costs or it may be necessary to eliminate certain costs that do not benefit purchased labor such as fringe benefits.

For example, consider the difference between in-house and offsite purchased labor. When purchased labor is used in-house, the guidance states normal overhead costs excluding fringe benefits may need to be allocated to purchased labor. When purchased labor is performed offsite where supervision and control is by an entity other than the contractor, none of the contractor's labor overhead costs may be allocable to purchased labor. When contractors use other practices they will need to show that either the impact is not significantly different or that it is justified.

## FINANCIAL RISK ASSESSMENT AUDITS

*(Editor's Note. Financial risk assessment and financial capability audits have become a hot topic in the light of recent corporate scandals. Whereas financial risk assessments and capability audits were usually limited to new contractors to ensure they could perform as well as to large contractors, now financial risk assessments must be conducted on an annual basis for most contractors. DCAA has extensively revised its audit guidance to accommodate the increased scrutiny of contractors' financial health and the following is to inform our readers of the likely steps DCAA will be taking to evaluate their financial capability to continue working with the federal government. The source for this article is the new audit guidelines first contained in the January 2002 edition of the Defense Contract Audit Manual.)*

The evaluation of a contractor's financial capability to perform government contracts really involves two distinct audit processes. The first step includes a financial condition risk assessment where potential red flags are identified. The second process includes a financial capability audit where the contractor's financial condition, near-term cash flows and longer

term capability to obtain additional funds are evaluated. In this article we will focus on the risk assessment steps since that is where the new audit requirements have been added.

The Defense Contract Audit Manual (DCAM) Chapter 14-300 covers financial capability audits and that section has been extensively expanded. Though many capability audits are performed in response to requests by contracting officers DCAA now stresses that auditors need to be alert to conditions indicating unfavorable financial conditions during the performance of their other audits. Now, field auditors must self-initiate an annual assessment of a contractor's financial condition to determine whether there is a need to conduct a financial capability audit. The financial assessment, discussed below, will be conducted either as a separate review or in conjunction with other audits.

The frequency of reviews has been increased. Each DCAA branch office is now required to conduct an annual financial condition risk assessment of the financial condition of both major and non-major contractors unless a risk assessment was performed and documented in other reviews during the year. For non-major contractors where there is no audit activity, a financial condition risk assessment will be performed at the first field visit during the next fiscal year. A detailed financial condition risk assessment should be performed every three years with modified financial condition risk assessments performed during the years when a detailed risk assessment is not performed.

### Financial Condition Risk Assessment Procedures

DCAA has developed a new audit program that identifies detailed steps for performing a financial capability audit. The audit program contains risk assessment steps the auditor needs to perform to determine the need for a financial capability audit. The detailed financial risk assessment consists of performing:

1. An analysis of the contractor's key financial ratios and trends along with a comparative analysis of these ratios with applicable average industry ratios.
2. An analysis of the contractor's financial data using one of the three Z-Score bankruptcy prediction models and a comparative analysis of the company's Z-Score with industry averages.

3. An evaluation of financial statement statistics for indicators of financial distress.
4. An evaluation of the adequacy of the contractor's internal controls related to financial planning and monitoring.
5. A follow-up on any other indicators that raise questions about the financial capability of the contractor.

The modified financial condition risk assessment, which is performed in the years the detailed risk assessment is not, includes:

1. Calculation and analysis of the trend of the contractor's key financial ratios without comparison to average industry ratios
2. Analysis of any significant events that the auditor becomes aware of that might impact the contractor's financial condition.

If indicators of financial distress are encountered during the modified risk assessment then it should be expanded to perform a detailed risk assessment.

Most of the new expanded audit guidance involves detailed guidance of the above steps.

#### ◆ Analysis of Key Financial Ratios

The analysis of key individual financial ratios are considered the primary data source for evaluating the financial health of the contractor. The guidance states the ratios need to be "used with care" where general rules of thumb should be avoided. Rather, the contractor's ratios should be compared with ratios found in the "applicable average industry ratios". Ideally the ratio analysis of the contractor and industry should cover three to five years of comparable data. For companies not publicly traded, the source of data should be the contractor's financial statements – Balance Sheet, Statement of Income and Statement of Cash Flows. The source of data for publicly traded companies as well as average industry ratios are maintained by DCAA at its Technical Support Branch.

At a minimum, the following key ratios are to be calculated and monitored:

1. Current Ratio (Current Assets/Current Liabilities). This ratio is used to measure a company's ability to pay its short term liabilities from its short term assets.
2. Acid Test or Quick Ratio (Liquid Assets/Current Liabilities). This measures a company's ability to

pay off its short term obligations from assets that are readily convertible to cash.

3. Return on Investment – ROI (Net Income/Total Assets). This measures economic performance and is used as an indicator of management effectiveness and ability to earn a satisfactory return.
4. Debt to Equity Ratio (Total Debt/Stockholders' Equity). Measures the relative size of creditors' claims compared to claims of owners.
5. Working Capital (Current Assets-Current Liability/Total Assets). The ratio of net liquid assets to total capitalization. Consistent losses will shrink current assets in relation to total assets.
6. Cash Flow to Debt (Cash Flow: Net Income + Depreciation + Depletion + Amortization/Total Debt). This is an indicator of available funds to satisfy debt obligations and is considered by many to be the best indicator of financial distress.
7. Cash Flow Return on Assets (Cash from Operations/Total Assets). Measures cash generated from operations as opposed to income.
8. Cash Flow to Sales (Cash from Operations/Sales). Shows the percentage of each sales dollar realized as cash.
9. Cash Flow Adequacy (Cash from Operations/Long term debt + Purchases of Assets + Dividends Paid). This measures ability to generate cash sufficient to cover cash requirements to pay debt, reinvest in operations and make distributions to owners.
10. Debt Coverage (Total Debt/Cash from Operations). Measures how many years it will take to retire all debt at current level of cash from operations.

The auditor is told to ask the contractor if there are other financial ratios that should be considered when evaluating their financial condition. The purpose of monitoring the ratios is based on the concept that as businesses deteriorate so do the key ratios. Similarly, comparison to industry averages provides another indicator of financial problems. When a contractor is experiencing a negative trend and it is worse than the industry average, red flags are raised requiring the auditor to perform a financial capability audit. *(Editor's Note. If certain financial ratios appear to be unsatisfactory, auditors may need to be reminded that privately owned companies or closely held corporations engage in perfectly acceptable financial practices that may affect financial ratios. For example, owners of a company may decide to take out*

*most of its wealth and then lease assets to the company while others may decide to keep most wealth in the company to minimize taxes. Such perfectly rationale actions can adversely affect certain financial ratios. We address how rational financial decisions made by smaller companies differ from standard business practices in an article in the first quarter 2003 issue – Vol 6, NO.1 - of the DIGEST.)*

### ◆ Failure Prediction Models

DCAA believes a bankruptcy prediction model is another key tool that provides insight into a contractor's financial health. Auditors are instructed to use one of the three "Z-Score" prediction models developed by Dr. Edward Altman.

A contractor falls into one of the three models. Model I represents publicly traded manufacturing companies (primarily SIC codes 2000 through 3999), Model II represents most privately held companies while Model III represents all remaining companies. The bankruptcy models take several variables corresponding to key financial ratios – working capital/total assets, retained earnings/total assets, earnings before interest and taxes/total assets, stockholder equity/total liabilities and sales/total assets – and assigns point scores to each variable and computes a weighted average score that takes into account the contractor's scores and how they compare against industry averages. (See Figure 14-3-2, The Altman Z-Score Formulas, in a recent DCAA Contract Audit Manual for additional information on the computation of Z-Scores.) DCAA maintains data for publicly traded companies and industry averages and also provides software programs for entering financial data and computing the prediction model scores.

Auditors are cautioned against putting excessive reliance on Z-scores but are told to use it as an initial indicator of financial problems. When using the Z-scores, auditors are encouraged to perform trend analysis of the current and previous two years as well as comparisons to industry averages. When the Z-Scores are below certain specified levels auditors are told a financial capability audit may be required. They are told to consider Z-Score trends, ratio analysis, financial statement evaluations and other indicators in deciding whether to go further.

### ◆ Financial Statement Indicators of Distress

In addition to the financial ratios discussed above, the new guidance points out that certain financial statistics of the contractor can provide additional insight into negative financial trends and distress. Common

conditions may include recurring operating losses, working capital deficiencies and negative cash flow from operations. To identify indicators of financial problems auditors are told to obtain financial statements for at least five of the preceding years as well as the current and forecasted fiscal years. The financial data from these statements should be analyzed and trend data compiled in the following areas: profit/loss, net income/loss from operations, cash flow from operations, cash flow from investing activities, cash flow from financing activities, sales, working capital (current assets minus current liabilities), noncurrent liabilities and total assets.

The guidance states auditors are to be alert to any lack of operating success evidenced in overall losses or net losses from operations. When these losses exist particular emphasis should be placed on reviewing cash flow in the ordinary course of business. Also, significant deterioration in sales or increases in liabilities should be monitored since these affect the contractor's ability to meet ongoing operations costs. If these statistics demonstrate the contractor is or will be in financial distress, DCAA should consider conducting a financial capability audit.

### ◆ Internal Controls

Auditors are also instructed to consider the adequacy of contractors' internal controls related to financial planning and monitoring. The internal controls to be evaluated should include: (1) written policies and procedures that require evaluation of current financial conditions in order to anticipate financial distress (2) preparation of cash flow forecasts along with documentation of assumptions (3) periodic assessments of accounts payable and accounts receivables that includes an analysis of aging and collectability of accounts (4) periodic assessments to ensure the company is compliant with loan covenants and debt payment schedules and (5) periodic assessment of contract cost performance.

### ◆ Other Indicators of Distress

This section of the guidance is intended to identify any other indicators that raise questions about contractors' financial distress. The guidance stresses that the auditors may become aware of significant indicators in their analysis of financial statements and accompanying notes, audit leads during prior audits, discussions with contractor personnel and other government representatives. Significant events and conditions to be alert to include:

First Quarter 2004

GCA DIGEST

- (1) defaults on loan/line of credit agreements
- (2) denial of usual trade credit from suppliers
- (3) restructuring of debt resulting in paying higher interest rates
- (4) noncompliance with loan/line of credit covenants
- (5) contracts in significant loss positions
- (6) legal proceedings/pending claims
- (7) loss of principal customers or suppliers
- (8) uninsured or underinsured catastrophes
- (9) labor strikes
- (10) unpaid taxes
- (11) contingent liabilities
- (12) deteriorating bond ratings
- (13) significant dollar amounts of accounts receivable
- (14) material defective pricing findings from post award audits
- (15) contract termination for default
- (16) deferral of payments to suppliers
- (17) failure to fund pension plans
- (18) loans from employees or issuing of stock to employees in lieu of salary
- (19) environmental clean-up impact
- (20) significant unpaid contractor debts
- (21) unusual progress payment or other billing concerns
- (22) parent company undergoing financial distress
- (23) physical condition of facilities
- (24) unpaid insurance liabilities.

In addition, the auditor and supervisors should discuss with the contractor any plans to enter into significant leases, make significant capital expenditures, liquidate assets, borrow significant cash or restructure debt, reduce or delay expenditures and increase ownership equity. Also, any unusual compensation

packages or outstanding loans to other company operations or offices that would drain financial resources from operating units having government contracts should be identified.

Once the applicable risk assessment procedures have been performed the conclusions should form the basis to decide to perform a financial capability audit. When the risk assessment is initiated by DCAA and no significant risk is identified then the results should be summarized in a memo for the record; when no significant risk is found for risk assessments requested by others (e.g. contracting officers) then the conclusions should be communicated to the requestor and the conclusion that no further analysis is warranted should be confirmed in a memo. If the requestor still desires performance of a financial capability audit or DCAA has decided that sufficient risk exists then a financial capability audit should proceed.

## **INDEX**

Knowing Your Cost Principles... NEW INTERPRETATION OF IR&D COSTS .....	1
ACCOUNTING SOFTWARE FOR GOVERNMENT CONTRACTORS .....	3
Classic Oldie... ACCOUNTING FOR CONTRACT LABOR .....	7
FINANCIAL RISK ASSESSMENT AUDITS .....	9