GCA DIGEST

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CASE STUDY - CREATION OF ONE OR TWO OVERHEAD RATES WHEN A NEW FACILITY IS ANTICIPATED

(Editors Note. The following is an edited version of a memo prepared for our client. Though the original memo addressed details of its product lines and manufacturing processes we eliminated those sections to keep the client's identity confidential and to highlight only selected considerations in deciding whether to change its indirect rate structure. Though the client is a manufacturing concern we should stress the same concepts apply to service firms with two or more locations.)

Our client was in the process of negotiating a $55 million contract (which it won) to manufacture several items of its major product line and asked us to prepare a disclosure statement in compliance with the cost accounting standards since the new contract would be CAS covered. Shortly after beginning work on the disclosure statement they indicated the large contract will likely require them to have an additional facility where two of their products would be manufactured and asked us several questions related to the new facility such as How do other government contractors approach this scenario? What will be the impact of moving two product lines out of their existing facility with respect to our being compliant with CAS? Will the move trigger a new set of separate overhead pools at the new facility to be spread down only to the products in the new facility or will the current overhead rate structure still be appropriate?

We said we are glad they brought this up before we proceeded with the disclosure statement and indicated the best time for making any changes would probably be now. Several factors should be considered in making their decision.

Pricing strategy

In our mind, this is the most critical issue because decisions about cost methodologies are not merely about accounting theory but should be based on the practical considerations of how the company wants to price its products. Unless you price items on a competitive or commercial item basis - catalogs, commercial market prices, GSA supply schedule - your prices negotiated with the government will likely be based on a cost buildup where allowable direct and indirect costs allocable to the items being offered will largely determine the price to be charged. Since the FAR and CAS provide considerable latitude in costing, you need to decide first on your pricing objectives. For example, are your items highly competitive with numerous other firms where low price is a significant factor in being awarded the contract. In that case, you will likely want to minimize or lessen the costs allocated to the items being sold to the government since you want to be able to offer a sufficiently low price to be competitive. On the other hand, if your items are unique and few to no other firms offer the products the government wants to buy, then you likely have greater pricing flexibility. In that case, you will probably want to maximize, or at least increase, the costs allocated to the offered items you are selling.

The analysis of pricing strategy should not be limited to a discussion between accounting personnel but should be informed by insights from the firm's marketing and senior level executives. Pricing strategy insight should be based not only on current opportunities but future opportunities because decisions made now will affect pricing in the future.

One or Two Overhead Rates?

Once you decide on your pricing strategy - does the item have to offer the lowest possible price or does it have considerable flexibility to charge a higher price - then you can decide on whether you want your cost allocations decisions to result in minimal or maximum cost allocations to the products being offered to the government. This decision will drive the amount of costs you allocate to the items which, in turn, will affect your decision to offer one or two overhead rates. *(Editor's Note. Of course other cost allocation decisions will also determine how much cost will be allocated to the contract. For example, deciding whether specific costs will be direct or indirect or if indirect, will be included in material burden or G&A pools will also significantly affect the level of costs allocated to the contract. However, as you have requested, this discussion will only address whether you will continue using one overhead* *rate or create a second rate applicable to the new facility and products manufactured there.)*

♦ Two overhead rates

If you decide that you have pricing flexibility on the items being produced in the new facility or you do not want to allocate those new facility costs (e.g. depreciation, rent, etc.) to the items being produced in the original facility then you will probably want to create a second overhead rate applicable to the products produced in the new facility. This is a relatively easy sell to the government because (1) there is a long held presumption that the more overhead rates used, the more precise cost allocations are (2) based on the belief of (1) auditors often encourage contractors to establish indirect rates at different facilities and locations (3) government auditors frequently interpret or at least cite FAR 31.203 and CAS 418 as reasons to resist use of one overhead rate at multiple locations and (4) a new case - AM General, discussed in the last issue of the DIGEST - concluded that two rates used at two facilities are appropriate. One word of caution - though most auditors will not conduct a sensitivity analysis to determine if more "favorable" (i.e. lower) pricing on a relevant contract would occur with a different indirect rate structure, certain aggressive auditors have been known to do so where they assert that more "equitable" pricing would result with a different structure.

♦ One overhead rate

If you decide that allocating higher expenses of the new facility to items produced there will result in an undesirable outcome - a higher allocation could result in a higher price you do not want to offer or you want to allocate some of the higher costs of the new facility to items being produced in the old facility - you will probably conclude that one company-wide overhead rate would be more desirable. In this case, you would need to be prepared to offer justification for the practice and counter government auditor challenges. In the past, our consulting practice has been successful in challenging various government arguments to create two overhead rates by offering some or all of the points presented below:

1. FAR does not dictate the number of overhead pools. The most common citations of FAR we have encountered that DCAA uses to support its position that two or more overhead pools should be used is FAR 31.203(b) and (d). The relevant section of (b) states "Indirect costs shall be accumulated by logical cost groupings with due consideration of the reasons for incurring the costs. Each grouping should be determined so as to permit distribution of the grouping on the basis of the benefits accruing to the several cost objectives." FAR 31.203(d) states that either CAS should rule if the contractor is CAS covered or otherwise generally accepted accounting principles (GAAP) should dictate where such factors as substantial differences in "cost patterns of work" between the contract and other work as well as significant changes in the nature of the business should be examined. The FAR references do provide general guidelines for determining cost groupings but in no way state multiple pools must be established. As for GAAP, there is even less guidance on the number of overhead pools that must be created.

2. Consistent with CAS. With respect to CAS, which will be applicable to the contractor, CAS 418 is the most relevant standard where there is a general requirement to create "homogeneous" cost pools. Like FAR, no cost accounting standard dictates the number of overhead pools that need to be created. Authoritative commentary (e.g. Accounting for Government Contracts, Cost Accounting Standards) have identified four things that need to be considered in determining whether the requirement of homogeneity has been achieved: (a) the cost in the pools should represent activities with a commonality of purpose (b) the cost pools should be a logical group of costs (c) the allocation base should have a direct causal relationship to the costs in the pool and (d) diversity of products should be minimal for each cost pool. These four criteria have been met - the overhead pool includes both a logical grouping of costs with a commonality of purpose (e.g. indirect costs in support of manufacturing operations), the allocation base of direct labor costs provides a direct causal relationship with the pool costs and almost all products produced by the firm are a variation of one product line.

3. Litton case makes one overhead rate OK. Before the *Litton* case, DCAA consistently challenged use of one overhead rate when there were multiple locations and the government generally supported the challenge. The Armed Services Board of Contract Appeals in *Litton Systems Inc. Guidance and Controls Systems Division (ASBCA No. 37131)* resolved the multiple versus one overhead rate issue of a major contractor that used one composite overhead rate for two divisions located in separate geographic areas. The Board concluded "the standard (CAS 418) does not mention the location of cost incurrence as a relevant factor nor is it relevant from a purely conceptual view…Nothing in CAS 418 or any other standard indicates that location of facilities or cost level of operations has any effect on the

characteristics of homogeneity of indirect cost pools as described in CAS 418.50(b)(1)."

MORE ON CHANGES TO THE ROLL FORWARD RULES

(Editor's Note. In the last issue of the GCA REPORT we reported that various industry groups have been challenging a recent move to discontinue the use of "roll forward" procedures, saying the new move severely retards timely establishment of final billing rates and contract close-outs. Several readers have asked for more clarity on this action so we have expanded the discussion here, incorporating further critical commentary by industry groups and contract specialists. We have incorporated the comments of Richard Johnson of the firm of SmithPachterMcWhorter, PLC written in an article in the September 2006 issue of CP&A REPORT and when referenced, a position paper prepared by the National Defense Industrial Association.)

Background

As most contractors know, it is quite common for the government and contractors to disagree about the allowability of certain costs submitted in incurred cost proposals. Eventually, these disagreements are often resolved but sometimes only after a considerable amount of time. Other times, the dispute continues, getting bogged down in repeated submittals, discussions with auditors, arguments and negotiations with contracting officers and even disputes with appeals boards or Court of Federal Claims. Either way, the overhead year remains open, preventing settlement of flexibly priced contracts as well as claims and terminations. Such delays in settling cost type contracts hurt not only contractors but also government agencies who have to return unexpended contract funds back to the treasury and then find new funds when additional contract costs are eventually settled.

To alleviate these problems, in 1997 the Defense Contract Management Command (DCMC) approved use of the "roll forward" of disputed overhead costs to the next open overhead year. This role forward permitted the early year to be settled and closed and the relevant contracts to be settled with the reservation that the disputed item(s) would be deferred to the open year closest to the year the costs were incurred and then included in that future accounting period when the cost allowability could be conclusively resolved. The DCMC initiative was broadly applauded as a way to alleviate the issue of indirect cost disputes and permitted a more orderly closure of indirect cost years, despite the existence of disputed costs. There was no disagreement raised by the normal accounting watchdogs of the government, including DCAA, the Government Accounting Office, the Cost Accounting Standards Board or any CAS experts.

DCMA's Reversal

Relying on a March 25, 2005 internal legal opinion the Defense Contract Management Agency (the new name of DCMC) reversed the prior DCMC position on September 23, 2005, shutting the door on roll forward of disputed overhead costs. In stating roll forwards should not be allocated in a future period, the DCMA stated that allocability of costs should be governed "exclusively by the regulations and standards of the CAS Board." Accordingly, once a contractor's CAS-compliant accounting practices had properly allocated a cost to a given indirect cost year, the cost may not be reallocated to another year because of a dispute about allowability. It stated the previously sanctioned roll-forward principle "was largely misconceived as a general principle."

In recognition that prohibiting roll forwards of dispute overhead costs will create problems for both contractors and government administrators, the DCMA guidance suggests that administrative contracting officers (ACOs) should consider six "alternative techniques":

1. Use FAR 42.708 "quick closeout" techniques which authorize final closeout of certain smaller cost-based contracts before indirect cost years are resolved.

2. ACOs should raise allowability questions sooner and attempt to resolve them more quickly.

3. ACOs should consider issuing notices of intent to disallow costs.

4. Encourage use of advance agreements between the parties.

5. Seek alternative dispute resolution before a formal dispute develops.

6. "Pay cost forward" where the disputed overhead cost would be paid upfront and be subject to a refund by the contractor. The pay cost forward alternative would require an advance agreement be executed to ensure the government will be paid back with interest and would apply to only those costs the government is "unclear" about.

Critical Commentary

As you would expect, there has been significant critical commentary generated about the change to the roll forward provisions. The commentary we have seen revolves around the fact that (1) the alternative techniques offered have little practical value and (2) the DCMA position misinterprets CAS 406 and generally accepted accounting principles pertaining to the time period when costs should be allocated.

♦ Impracticality of the Alternative Techniques

While the first has limited applicability, the next four techniques work only if the parties agree to them, which is unlikely if there are serious overhead disagreements. Specifically:

1. Quick closeouts. Quick closeouts, which allow for closing out contracts before indirect cost years are closed, have limited applicability. They are limited to allocations of indirect costs to any one contract worth up to $1 million and the accumulated allocation, absent special considerations, cannot exceed 15 percent of total unsettled indirect costs for a single year.

2. Raise allowability questions sooner and resolve them quicker. This, of course, requires the parties' agreement which seems difficult since the lack of agreement underlies the roll-forward controversy.

3. ACOs issue intent to disallow costs. This is also unhelpful since an ACO can issue notices which instead of prompting settlement simply pushes the disagreement to the next stage of Contract Dispute Act arbitration or litigation.

4. Issue advanced agreements. Such agreement require a meeting of minds between the parties where significant disputes, by definition, lack agreement.

5. Use alternative disputes resolution (ADR) before formal dispute develops. ADR usually requires agreement of both parties because otherwise neither party in significant overhead cost disputes are willing to opt for binding ADR since they want the option of going further if they dislike the ADR result.

6. Pay cost forward. Though more promising, the guidance for implementing this solution also limits its applicability. This alternative permits the government, after execution of an advance agreement, to expend funds on paying the contractor which the government favors since it avoids reversion of the funds back to the government. However, the model advance agreement DCMC has included in its guidance has generated some critical comments:

First, paragraph 3 of the model makes the cost principles in effect on the date of the agreement applicable to all future contracts, making future FAR changes that may be favorable to the contractor irrelevant.

Second, paragraph 5 is confusing where the first sentence states the contractor will identify the allocation of the disputed costs and keep records for all contracts while the second sentence says the costs will be identifiable only to "cost-based pricing proposals." The second sentence properly limits the impact to only those contracts where price was based on a cost buildup while the first improperly applies the impact to all contracts.

Third, paragraph 6 states that if the issue is resolved against the contractor it will pay the government in full for "the total amount of costs determined to be unallowable." This is improper because the overhead cost determined to be unallowable may be allocated not only to government contracts which are cost based but also all contract work which may be commercial, non-cost based or subcontracts (where the roll forward rules do not apply). The government should have no right to any of these latter allocations which the agreement would create as well as add interest for the amount owed.

Fourth, paragraph 6 does add that no reimbursement will be required for contracts priced on a commercial item basis but the addition is not complete since it excludes those contracts based on full and open competition, prices set by law or regulation and others where price was not cost-based.

Fifth, paragraph 7 states the agreement does not waive penalties for expressly unallowable costs. It is difficult to envision a cost that the ACO "may ultimately find..allowable" would fit the definition of "expressly" unallowable but the model agreement allows the government to assert the costs were expressly unallowable and hence impose penalty costs.

Finally, paragraph 8 states either party may cancel the agreement on 30 day notice. This is obscure because prior to cancellation the contractor presumably would have been paid the costs involved subject to repayment but the cancellation would seem to eliminate the contractor's obligation for repayments.

♦ Misunderstanding of CAS 406

DCMA's position is that CAS 406 (see our discussion of CAS 406 below) - or generally accepted accounting principles (GAAP) for non-CAS covered contractors - require that all costs have a single "correct" cost accounting period to which they must be assigned. The National Defense Industrial Association has expressed the opinion that this premise is incorrect. Rather than calling for a single "correct" period, they state CAS 406 and GAAP prescribe criteria for the selection of time periods to be used as a cost accounting period not for determining the one proper cost accounting period for assigning a cost. NDIA cites many examples of costs that are incurred in one period and under various circumstances, are assigned to future circumstances such as deferred independent research and development, amortization of internally developed software costs and restructuring expenses. Mr. Johnson provides another example where pension cost are incurred in the period in which the benefit is earned and is normally assigned to that period yet CAS 412-50(c)(2) requires that certain pension costs be rolled forward as a prepayment credit for reimbursement in future years.

Classic Oldie...

FINANCIAL DATA COMPARING PROFESSIONAL SERVICES CONTRACTORS

(*Editor's Note. Most firms want to know how they compare with others. Unfortunately, most useful information is proprietary and almost all surveys we encounter are limited to generally useless financial data extracted from annual reports of publicly traded companies. The exception to this rule was an annual survey published by Wind2Software, Inc. which was acquired by Deltek last year. We used to present the results of the survey each year but unfortunately the survey ended after the acquisition. However, since the results differed little from year to year, we thought it would be useful to present the latest results for 2004. The survey was unique because it surveyed actual firms of varying sizes and offered very relevant data for government contractors. It surveyed a broad range of professional services companies such as engineering, architecture, environmental, etc. and we found the results closely mirrored those of most professional service organizations. This was not surprising since most labor intensive businesses incur similar costs.*)

The Wind2 Software survey presents a wide range of useful information: comparison of data for each year from 1978-2004, profit and loss statements, key financial ratios (e.g. current ratio, average collection periods), identification of key overhead cost elements (e.g. all fringe benefits, insurance, indirect labor, depreciation, marketing costs etc.), key measures of productivity, and other financial measures (e.g. work-in-process incurred but not billed, number of firms that charge interest on late accounts). The following table and explanations represents a selection of measurements for 2004 we chose that will provide interesting comparisons for our government contractor readers. For those who (like us) forget statistics terms, "mean" refers to an average while "median" refers to a midpoint.

Summary of Key Ratios

Ratio	Mean	Median
1. Net Profit Before Tax and Distribution on Total Revenue (%)	10.69	9.15
2. Net Profit Before Tax and After Distribution on Total Revenues (%)	5.93	3.71
3. Net Profit Before Tax on Net Revenues Before Distributions (%)	12.52	10.90
4. Net Profit Before Tax on Net Revenues After Distributions (%)	6.74	4.36
5. Contribution Rate (%)	61.64	64.03
6. Overhead Rate Before Distributions (%)	144.92	143.99
7. Overhead Rate After Distributions (%)	162.82	168.31
8. Net Multiplier (X)	2.91	2.91
9. Net Revenues per Total Staff ($)	96,520	93,163
10. Net Revenues per Technical Staff ($)	121,017	115,635
11. Net Profit Before Distributions per Total Staff ($)	14,312	10,640
12. Net Profit After Distributions per Total Staff ($)	8,169	4,590
13. Net Profit Before Distributions per Technical Staff ($)	18,178	13,580
14. Net Profit After Distributions per Technical Staff ($)	10,542	5,544
15. Chargeable Rate (%)	63,35	62.62
16. Unallowable Overhead as a Percent of Direct Labor (%)	17.32	9.03
17. Unallowable Overhead as a Percent of Total Overhead Before Distributions (%)	12.41	7.56
18. Unallowable Overhead as a Percent of Total Overhead After Distributions (%)	10.55	6.77
19. Unallowable Overhead as a Percent of Total Revenues (%)	5.29	3.20

20. Unallowable Overhead Before Distributions as a Percent of Direct Labor (%)	127.22	127.70

1. Net Profit Before Tax and Distribution on Total Revenues. This factor measures the percentage of net profit (income) before taxes and distributions (bonus, profit sharing, etc.) based upon annual total revenues (net revenues plus consultants and reimbursables). For many firms, where bonuses and profit sharing are not considered an annual benefit of employment, this figure is more meaningful than the after distribution net profit ratio (see next item). This ratio is calculated by dividing profit before tax and distributions by annual total revenue.

2. Net Profit Before Tax and After Distributions on Total Revenues. This ratio provides a measure of the percentage of net profit (income) before taxes based upon annual total revenues. It is calculated after distributions for bonuses, profit sharing, pension programs and the like. For many firms, particularly those with a heavy reliance on outside consultants, it is not as meaningful a figure as are the net profit on net revenue measures (see items 3 and 4). This ratio is calculated by dividing profit before tax and after distributions by annual total revenues.

3. Net Profit Before Tax and Distributions on Net Revenues. This factor is the same as number 4 below, except that this percentage is calculated before distributions. Net revenue calculations are more meaningful than those based on annual total revenues for those firms that use sizable amounts of outside consultants or have large reimbursable expenses or both. The calculation uses profit before tax and distributions divided by net revenue.

4. Net Profit Before Tax and After Distributions on Net Revenues. This index measures net profit (income) before taxes based upon net revenues. As a result, it bases profit percentages only on your efforts and not on consultants and reimbursables. It is calculated after distributions for bonuses, profit sharing, and the like. The calculation uses net profit before tax, but after distributions, divided by net revenues.

5. Contribution Rate. The contribution rate is the portion of each dollar of net revenues remaining after all direct project costs (both labor and expenses) are covered. Thus, it is the contribution of each fee dollar to overhead and profit. It is calculated by dividing gross profit by net revenues.

6. Overhead Rate (Before Distributions). The overhead rate is the percentage of total office overhead to total office direct labor. Overhead also includes that portion of principal's time that is not chargeable to projects. This ratio is calculated by dividing total overhead (before distributions) by total direct labor expense (raw labor without fringes). What the survey refers to as "overhead" is what many firms consider indirect costs, which often includes overhead and general and administrative costs.

7. Overhead Rate (After Distributions). The after distribution overhead rate includes bonus, profit sharing, and other discretionary distributions as part of the overhead rate and not separately as a distribution of profit. If your firm considers these items an annual business cost, then this after distribution factor is more meaningful for you. This overhead rate is calculated by dividing total overhead, plus discretionary distributions, by total raw direct labor expense.

8. Net Multiplier. This is the effective multiplier firms achieved on direct labor (it is not the target multiplier). It is calculated by dividing net revenues by direct labor and is more meaningful than a gross multiplier (which includes consultants and reimbursables) in that it calculates the actual multiplier you achieve on your own efforts.

9. Net Revenues Per Total Staff. This rough productivity index measures the dollar amount of net revenues each employee or part-time equivalent represents. Calculate this figure by dividing net revenues by average total staff, including principals and part-time equivalents.

10. Net Revenues Per Technical Staff. This index is calculated by dividing net revenues by the average total technical staff (defined as including all planning or design professionals technicians and employees who work on projects, including principals). Some managers feel that this ratio is a more accurate representation of general productivity than revenues per total staff because it assigns revenues to those who are directly responsible for generating them.

11. Net Profit Before Distributions Per Total Staff. Calculate this ratio by dividing net profit before tax and distributions by your average total staff, including part-time equivalents and principals. Before-distribution profit measures are often more useful than after-distribution figures for those firms that do not treat bonuses and profit sharing as an expected, annual benefit of employment.

12. Net Profit After Distributions Per Total Staff. Each member of the staff represents a dollar figure of net profit before tax. The figure is calculated by dividing net profit before tax and after distributions by your average total staff, including part-time equivalents and principals.

13. Net Profit Before Distributions Per Technical Staff. This figure is calculated by dividing net profit before tax and distributions by the average technical staff as defined in item 16 (revenues per technical staff).

14. Net Profit After Distributions Per Technical Staff. This figure is calculated by dividing net profit before tax and after distributions by the average technical staff as defined in item 16 (revenues per technical staff). As noted earlier, some managers feel that profit per technical staff measures are a more accurate representation than profit per total staff, because it assigns profits to those who are directly responsible for generating them.

15. Chargeable Rate. This ratio measures the percent of total staff time charged to projects (whether later billed or not). It is calculated by dividing total direct labor by total firm labor (direct labor plus indirect labor and vacation, sick leave, and holiday time actually paid).

16 and 19. Unallowable Overhead as a Percent of Direct Labor and Total Revenues.
This figure is of primary interest to those firms that work for U.S. government agencies. It consists of the total overhead either deleted by contractors or disallowed by government auditors, expressed as a percent of direct labor. For internal management purposes, unallowable overhead should be included in total overhead.

17 and 18. Unallowable Overhead as a Percent of Total Overhead Before and After Distributions. This ratio is calculated by dividing unallowable overhead by total overhead before distributions.

20. Unallowable Overhead as a Percent of Direct Labor. This factor shows the actual overhead rate (before discretionary distributions) allowed to firms after removing unallowable costs. Note the significant variance between firms' actual rate (before and after distributions) and this item's median. For many firms this unallowable portion comes directly out of profit.

Knowing Your Cost Principles and Cost Accounting Standards...

COST ACCOUNTING STANDARD 406

(Editor's Note. In our continuing series on cost principles and cost accounting standards, we address here what constitutes a proper accounting period for contract costing and estimating purposes. The issue is "hot" these days (see the article above on roll forward rules) and the standard is one of four that officially apply to modified CAS covered contracts. We have used several texts and course material accumulated over the years where our favorite is still Accounting for Government Contracts, Cost Accounting Standards, published by Mathew Bender.)

CAS 406 establishes the general rule that the contractor must use its fiscal year as its cost accounting period. It requires the contractor to follow consistent practices from one cost accounting period to the next when selecting periods for accumulating and allocating costs or any type of adjustment. The standard also requires the period used for accumulating costs in an indirect cost pool reconcile with the period used for establishing the pool's allocation basis. This article will expand on these ideas, clarify exceptions and address a few related issues.

The stated purpose of the standard is "to provide criteria for the selection of the time periods to be used as cost accounting periods." Its intent is to reduce the effects of variations in the flow of costs within annual accounting periods. The CAS Board also added that a prime objective is to make sure that adjustments to direct and indirect costs need to be consistent.

General Rule for a Cost Accounting Period

Fiscal Year Concept. If the period of contract performance is shorter than the contractor's fiscal year some accountants argue that only those indirect costs incurred during the contract performance should be charged to the contract. This runs counter to CAS 406 because the purpose of the standard is to minimize the affect of erratic flows of indirect costs that may be high in some months and low in others or those costs that are stated only on an annual basis (e.g. depreciation, taxes, insurance). To make sure erratic costs are smoothed out for the year and annual costs are properly recognized, CAS 406 states the appropriate cost accounting period for determining total costs applicable to a contract is the fiscal year, not the period of time a contractor may work on a contract. An example is provided to emphasize the point where the practice of estimating general management expenses (pool of costs) and total expenses (the allocation base) for the eight month period of performance is cited as non-compliant with CAS 406.

Annualized Forward Pricing Rates. When estimated rates are used for pricing purposes, the standard requires use of annualized budgeted or estimated rates to overcome volatility of overhead costs resulting from seasonal or cyclical variations as well as the fluctuations of the base costs such as direct labor. For example, while fixed costs (property taxes, rent, depreciation) will not fluctuate, variable costs (e.g. supplies, indirect labor) will vary with business while other costs will simply be erratic for other reasons (e.g. vacation and holiday pay during summer and Christmas, idle facilities costs due to installing new equipment, social security late in the year when the wages exceed the table maximum). To compute "normal costs" all the peculiarities of costs are collected in an annual cost pool and then an indirect rate is calculated that distributes month-to-month fluctuations over the entire year.

Monthly Allocations. Needing to use interim billing rates to charge the government for completed work, contractors commonly developed monthly billing rates reflecting costs incurred each month. The CAS Board held such monthly cost accounting periods were inappropriate because it allowed for too much manipulation of cost allocations. It should be noted that though the standard specifies use of annual rates, rates computed differently may be acceptable if they are representative of annual rates but the burden of proof falls on the contractor.

Exceptions to the General Rule

CAS 406 provides four exceptions to the general rule that the cost accounting period is the contractor's fiscal year. These exceptions occur when:

1. An indirect function exists for only part of a cost accounting period. Examples include a planned computer facility put on line in the seventh month of the year or decentralization of some functions during the last quarter resulting in new levels of supervision. The costs of such indirect functions may be allocated for those periods if the costs are (a) "material in amount" (b) "accumulated in a separate indirect cost pool" or (c) "allocated on the basis of an appropriate direct measure of activity or output of the function during that part of the period." The standard provides an example of an acceptable treatment where a new computer service center represents material amounts of costs, is separately accounted for and the costs are allocated during the 8-month period on an appropriate output basis. The standard does not require that every function in existence for part of the year be allocated over shorter periods, only that the contractor may do so.

2. The contractor has an "established practice" of using a cost accounting period other than the fiscal year. A typical example would be a "model year."

3. The contractor changes its fiscal year and must use a transition period. When it changes its fiscal year the contractor may choose among three transitional cost accounting periods: (a) short period - from the end of the contractor's prior cost accounting period to the start of the new accounting period where this period is less than a year (b) long period - longer than a year but no more than fifteen months where this period is obtained by adding the short period to the contractor's prior cost accounting period (c) long period - also longer than a year but no more than fifteen months where it is obtained by adding the short period to the contractor's next cost accounting period. An illustration is provided in the standard where a calendar year is changed to a 12 month period ending May 31. This five month transition period may be used as a transitional cost accounting period but it may not be added to either the prior or next period because it would be longer than 15 months.

4. The Renegotiation Board regulations require use of a different cost accounting period.

Accounting Period for Pools and Bases

The standard provides that the same cost accounting period must be used for accumulating costs in an indirect cost pool as that for establishing its allocation base. This is the case not only for actual costs but also applies to estimating for proposal purposes. For cost accumulation, the contractor must match the costs to the same period as the allocation base that relates to the costs.

The CAS Board indicated that "appropriate expedients" could be used if it was not expected to materially affect the rates. So, it acknowledged that contractors may find it necessary to use actual and estimated data to comply with the standard. Also, it recognized a contractor may use an annual period not precisely coinciding with its cost accounting period under certain circumstances: the practice (1) is necessary to obtain "significant administrative convenience" (2) is consistently followed (3) the annual period is representative of the activity of the normal cost accounting period and (4) the practice results in an allocation not "materially different from using the same cost accounting period for cost pool and allocation base."

Consistency is Required for Accrual, Deferral and Adjustment Practices

CAS 406 provides that a contractor must follow consistent practices in selecting the cost accounting periods for accumulation and allocating any expense and type of adjustment to expenses (including prior period adjustments). It is quite common for some expenses (e.g. taxes, insurance, employee leave) to be identified with fixed, recurring annual periods different from the contractor's accounting period. The standard permits use of such separate annual periods other than the contractor's accounting period provided the expenses are assigned to cost accounting periods in accordance with the contractor's established practices. The standard provides an illustration where it is acceptable to adjust employees' vacation expenses in October 2XX1 for its "vacation year" ending September 2XX1 in spite of the fact that the fiscal year ends November 2XX1 since this is its established policy. Or, for example, the contractor pays all salaried employees on the 25th of each month for the entire month even though there is really a receivable from the employee for the remaining period of each month.

Accruals and Deferrals. An accrual is an adjustment where revenue or expense is recognized in a period prior to the period a related cash receipt or payment occurs while a deferral refers to a situation where revenue or expense is recognized in a period subsequent to the period of cash receipt or determination an obligation exists. Adjusting entries are often required to make certain a cost accounting period reflects proper amounts of costs for that period where accountants normally believe there is a need for adjustments to keep the accounting system on an accrual basis. Adjustments may be needed when many accounts are maintained on a cash basis and need to be adjusted to keep the accounting system on the accrual basis or may be necessary to update certain accounts such as inventories.

Prior-Period Adjustments. A prior period adjustment is usually needed to correct an error such as a mathematical mistake, mistake in applying an accounting practice or oversight or misuse of facts. Neither the CAS nor FAR provide requirements for handling prior-period adjustments but under Generally Accepted Accounting Practices there are three approaches available: (a) restatement method - retroactive adjustments to a prior period (b) cumulative effect method - assigns an adjustment to the current period and (c) current and prospective method - spreading the cumulative effects over the current and future periods. Only adjustments that are material should be made. Under government contracts where the restatement method may not be practical for completed or closed out contracts, the cumulative method is commonly used to adjust previous depreciation costs when an asset is disposed of and errors in depreciation expenses are often best covered under the current and prospective method.

Use of Estimates for Contract Closing

CAS 406 does not require that the indirect cost allocation rates used to expedite the closing of contracts be based on the actual data for the annual cost accounting period. The standard allows for use of rates based on estimates developed for the purpose of closing out contracts that are terminated or completed before the end of the accounting period. The Bender text provides an illustration where the contractor uses a calendar fiscal year and it completes a three year cost type contract in February. It submits closing papers showing a 125% overhead rate based on two months of actuals, the auditor recommends using the prior year's overhead rate of 95% and the expected rate based on estimates is 110% and the question is what cost accounting period should the contractor use. The answer is the that since the contract ends during the last fiscal year of the contract estimates of annual overhead rates may be used as long as they are developed from data representing a full cost accounting period.

CONTRACT FINANCING TERMS

(Editor's Note. Doing business with the government is its own world and has its own terminology, especially when it comes to contract funding. We find that few contracting and accounting specialists, including ourselves, have a thorough familiarity with the terms. We find it useful to have a basic understanding of financial terms not only because we often see terms thrown about in the media but a basic understanding of the way government customers do business provides insight into both the limits and opportunities available to obtain funds for products and services. In our periodic review of prior issues of relevant periodicals we came across an interesting two part series in Contract Management (June 2001 and May 2002) by Diane Mercurio, an attorney with the Department of Defense, and decided to

condense her voluminous articles into the most relevant one part article we could come up with.)

Appropriation. Annual funding to federal agencies. Funds are then generally available for limited time periods and agencies are legally obligated to use the money within the availability period. Fixed appropriations are cancelled five years after the availability period starts.

Antideficiency Act. This act prohibits government officers or employees from making or authorizing an expenditure or an obligation (1) in excess of allotted funding amount (2) in excess of formal subdivisions of funds or permitted under regulations or (3) in advance of an appropriation unless authorized by law. It also prohibits accepting voluntary services unless authorized by law.

Apportionment. The Office of Management and Budget distributes funds for specified time periods, activities, projects or objects. Funds are apportioned to prevent agencies from obligating at a rate that would create a deficiency or need for additional funding.

Augmentation. An agency action increases the fund amount available in the agency's appropriation which causes the agency to spend more than the amount originally appropriated by Congress. Agencies are prohibiting augmenting funds without authorization and augmentation that includes transferring funds from one account to another. Such transferring essentially expands the funding pool for a project and is not permitted.

Authorization. An authorization act annually clarifies an appropriation's intended purposes or restricts use of appropriated funds.

Bona Fide Need. Agencies must demonstrate a bona fide need for a specific period before an agency may obligate funds. An inquiry into a bona fide need focuses on the obligation of funds' timing and demonstration of a current government need.

Cancellation. A cancellation ends the requirements of all remaining program years. Unlike termination, it occurs between fiscal years or at the end of a program year and must apply to all subsequent fiscal years' quantities of items. A contract or program is generally cancelled when funds are not available.

Cancellation Ceiling. This charge is the maximum amount the contractor can receive if the contract or program is cancelled.

Closed Appropriations. These are appropriations no longer available for any purposes. An appropriation becomes "closed" five years after the end of its availability period as defined by the applicable appropriation act.

Color of Money. This term refers to the funds' purpose. The various types of appropriations are operational and maintenance (O&M); personnel; research, development, test and evaluation; procurement; shipbuilding and conversion; military construction, multiple year; working capital; and no-year appropriations. O&M and personnel programs are funded each year.

Commitment of Funds. A commitment is the administrative or formal reservation of funds based upon firm procurement requests, orders, directives and equivalent instruments. An obligation equal to or less than the commitment may be incurred without further approval of a certifying official.

Contingent Liability. This liability is contingent upon an event occurring before it becomes an agency obligation. Such a liability cannot be recorded as a valid obligation until the event occurs. Examples include escalation, price redetermination or funds made as part of incentive clauses. While contingent liabilities do occur, agency finance departments do not like them.

Continuing Resolution. Often called a "stop-gap measure" it is required for an agency to continue to fund operations for a fiscal year when no new fiscal year appropriation bill has passed. Interim funding is simply conferred until Congress enacts permanent legislation.

Current Appropriations or Funds. These are funds whose availability for new obligations has not expired under the terms of the applicable appropriations act. An interchangeable term is unexpired appropriations.

Deobligate. Just as the government must obligate finds when it incurs a liability it must also "de-obligate" funds when it reasonably expects to not incur a liability. This is especially important before the end of the fiscal year, when many funds face expiration.

Disbursement. Government payment usually in the form of a check or electronic deposit. A disbursement on a contract should be made only for contracted work in the same scope and effort.

Economy Act Orders. This act authorizes interagency orders where the ordering agency must reimburse the performing agency for costs of supplying goods or services.

Expired Appropriations or Funds. Expired funds retain their fiscal identity and are available to adjust and liquidate previous obligations. Fiscal year identify is retained for five years after the availability period ends.

Extraordinary Contractual Relief. Public Law 85-804 grants the president the power to authorize agencies or departments to provide extraordinary emergency relief if doing so promotes the national defense. Government contractors may request this type of extraordinary assistance in cases of extreme financial hardship during contract performance.

Fiscal Year. The period from October 1 to September 30.

Full Funding. A program has full funding when all funds are available at award to cover the contract's total estimated cost. Full funding does not exist if a future year's appropriation is required for delivery.

Future Years Defense Program (FYDP). The Secretary of Defense's approved plans and programs for DOD. This is the sole official, annual program for which a contract must be identified with before an agency may expend monies. Civilian agencies have similar, approved program plans for each fiscal year.

Imprest Funds. An imprest fund contains a fixed amount established by advanced funds. A disbursing officer can provide such funds to a duly appointed cashier for cash disbursements in relatively small amounts without charging to an appropriation.

Military Interdepartmental Purchase Request (MIPR). MIPR uses Government Form DD448 to transfer funds from one defense agency to another. Such an interagency obligation is recorded the same way any other contract is recorded.

Necessary Expense Rule. This requires a logical connection between fund purpose and fund spending. An expenditure is permissible if it is reasonably necessary to carry out an authorized function or will contribute materially to the function's accomplishment.

New Obligational Authority. The only time an agency can proceed with certain initiatives that were not in the fiscal year's approved budget is when Congress specifically grants the authority to incur obligations.

Nonappropriated Fund Instrumentalities (NAFIs). NAFIs are unique in that these entities recover their money to operate from sale of goods and services, not from congressional appropriations. There is no accountability for NAFIs in the fiscal records of the US Treasury. They provide essentially morale, welfare and recreational support and are engaged in certain religious and educational programs.

Nonseverable Services. A service is nonseverable if it produces a single or unified outcome, product or report that cannot be subdivided for separate performance in different fiscal years. Hence, the government must fund the entire effort with money available for obligation at the time the contract is executed, even if contract performance crosses many fiscal years. In contrast, severable services can be separated into components that independently meet a separate need. Generally, severable services are the needs of the fiscal year in which they are performed. Requested services then must be paid from that respective fiscal year's funds or with dollars available when the contractor performs the services.

Nonrecurring costs. These are costs generally incurred on a one time basis. Example may include plant or equipment relocation, special tooling and testing equipment and preproduction engineering.

Obligation. This term refers to the legal obligation to pay appropriated funds. Any obligation must be officially charged to an appropriation. The general fiscal law rule is that the government must obligate current funds as it incurs a liability.

Offsetting. The mechanism by which an agency can apply user fees and other receipts to its accounts without depositing into the US Treasury general fund.

Overobligations. These are violations of the Antideficiency Act when an agency, through a government employee, incurs obligations for which funds are not available.

Procurement request (PR). The approval of a PR signals internal agency approval to proceed with a program or initiative. The term is usually interchangeable with purchase requests. A PR describes requirements and requests a specific contract action (purchasing) by an agency's contracting officer.

Ratification. When legally appropriate, ratification approves an unauthorized commitment. An unauthorized commitment occurs when a government representative who lacks authority enters into an agreement with a contractor and then attempts to authorize funds. An agency official with proper

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authority must then approve the unauthorized commitment or the agreement remains invalid. Before ratification occurs, an agency must determine that funds are available and were available at the time the individual made the unauthorized commitment.

Reprogramming. This is a request for the reapplication of funds and is not considered a request for additional funding. Reprogramming requests are less formal than transfer requests.

Sequestrations. The law provides mechanisms for spending reductions or sequestrations, if spending will exceed a cap. Sequestrations may occur at several points during the fiscal year. A government employee may not authorize an expenditure or obligation for the payment of money to be sequestered.

Severable Services Exception. The exception to the general requirement to pay severable services performed in a certain year with that year's funds allows an agency to fund severable service contracts for up to one year with current funds even if the contract crosses fiscal years. This exception has become common and helps avoid the end-of-the-year rush and funding gap issues.

Transfer. A transfer of budget authority is a shifting of money form one appropriation or fund account to another. Agencies can transfer funds between accounts within an agency, between agencies or with accounts that are subdivided. The two types of transfer authority are general and specific authority and Congressional approval is required.

User Fee. Charged to users for goods and services provided by the federal government. The fees generally apply to federal activities that provide special benefits to identifiable recipients and relate to the costs of goods or services provided. They are usually considered an offset receipt and hence available to the agency. A user fee is distinguished from an excise tax that must be recorded as a budget receipt.

Working Capital Fund or revolving fund. It operates as an accounting entity. They are management tools that provide working capital for the operation of certain activities including industrial and commercial activities. In the fund assets are capitalized and all government income is in the form of offsetting collections derived from the fund's operations. The receiving activity must reimburse the revolving fund account for the goods and services provided. All monies are available to finance the fund's continuing cycle of operations without fiscal year limitation.

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