

---

# GCA DIGEST

(A publication of Government Contract Associates)

---

Fourth Quarter 2011

Vol 16, No. 4

**Oldie but Goodie...**

## **DCAA AUDITOR IDENTIFIES HOW HE WOULD CONDUCT AN ACCOUNTING SYSTEM REVIEW**

*(Editor's Note. Probably our most common consulting engagement is conducting an evaluation of our clients' accounting practices before auditors come in to conduct their own audit. Some of our clients, quite smartly, ask us to conduct a "mock" audit where we put on our auditor cap, go through many of the steps an auditor will go through, identify weaknesses and strengths and recommend and often help implement fixes (e.g. prepare written policies). We came across an article a few years back written by a DCAA auditor who provided a first-hand account of what they examine. Increased scrutiny of contractors' accounting systems these days make this highly accurate account of what to expect even more timely so with a few updates, we are providing the article again.)*

We could not resist recounting an article by Anthony Destefano in the May 2004 issue of Contract Management where the author provides a clear description of what auditors will be examining. The article is unique because Mr. Destefano is currently an auditor with the Defense Contract Audit Agency where we find his reporting on what to expect during a review of the accounting system to be unusually clear and accurate. The article stipulates the opinions are the writer's and not those of DCAA.

The accounting system must be in accordance with Generally Accepted Accounting Principles (GAAP). The auditor will conduct certain tests to make sure the contractor has, or if not, intends to have an *accrual* basis accounting system. It is also best if the contractor has financial statements compiled, reviewed or audited by an outside CPA firm.

*Controls for distinguishing direct and indirect costs.* The author states the evaluation checklist found in the FAR Standard Form 1408 will be followed. The contractor must have controls to preclude the direct charging of indirect expenses and vice versa. A flowchart or similar document is most helpful in demonstrating the flow of expense transactions from say a purchase requisition to a purchase order to a receiving document and then to the vendor invoice. For service-related expenses, a formal contract, subcontract or engagement letter is "helpful" in determining whether an expense is direct or indirect. The charge number (direct or indirect) should be shown on the documents at the earliest possible stage. Also, a system of review and approvals are considered essential in meeting this requirement. It is also important for the contractor to prepare and maintain written policies and procedures for the identification

of direct and indirect costs and these policies disseminated to employees preparing and reviewing relevant documents.

*Job-Cost Ledger.* The contractor must have either a subsidiary job-cost ledger or accounts receivable ledger that accumulates costs by contract at a level consistent with that used by the contractor (e.g. contract, task or delivery order, contract line item).

*Indirect Cost Rates.* The auditor will determine whether indirect costs are accumulated in logical cost groupings (called pools) and the costs must be allocated on a causal or beneficial relationship with the base. For example, a facilities cost pool would not include costs of the accounting or personnel department. The contractor should have a chart of accounts that shows how indirect costs are grouped in relevant pools and will be asked to produce a current general ledger trial balance that matches the chart of accounts. It is important that the contractor formally document its cost accounting system in a written description of the contents of the pools and bases

*General Ledger.* The next requirement is that costs be accumulated under general ledger control. This is a test that should be conducted before DCAA begins the audit. Simply, the contractor's job-cost ledger must reconcile with the general ledger. For example, on-site labor posted to each contract in the job-cost ledger must equal the same on-site labor account posted to the general ledger.

*Timekeeping System.* SF 1408 requires "a timekeeping system that identifies employees' labor to the appropriate cost objective" (e.g. contract, subcontract, relevant task or delivery order, IR&D/

B&P project, cost pool, etc.). This requirement is supposed to be simple but it causes contractors the most trouble both in getting employees to comply and generating negative findings during floorchecks by auditors. The author states timesheets or timecards, whether manual or electronic, should be prepared and that the documents be signed by employees and supervisors. (*Editor's Note. Though not mentioned by the author, additional requirements often cited as deficiencies are failure to complete timesheets each day, provide visibility of all changes – no "white outs", and enter "start-stop" times when multiple projects are normally worked on and a written policies addressing expense reporting, screening unallowable costs and government contract accounting, a written policy and procedure on accurately completing the company's timesheet or timecard.*)

*Labor Distribution.* The SF 1408 mandates a labor distribution system for proper assignment of direct and indirect costs. The labor distribution reports summarize labor charges by employees and cost objectives. Contractors need to determine that labor distribution reports reconcile to the payroll register each period and that they reconcile to corresponding general ledger accounts. (*Editor's Note. Use of labor distribution reports often represents the greatest gap between contractors' practices and government requirements because it is not a very common element of most companies' practices – or at least companies do not use the reports even if their systems are capable of providing for them - while auditors often insist it be in place.*)

*Monthly Posting.* Auditors are instructed to make sure contractors post direct and indirect contract costs at least monthly to the books of account (e.g. general ledger, job cost ledger, labor distribution reports and other subsidiary reports). GAAP needs to be followed so that year-end postings of certain costs such as depreciation, defined benefit pension costs, accounts payable, employee leave accounts, etc. will be estimated and posted monthly and then adjusted to actual costs at year end.

*Exclusion of Unallowable Costs.* Every contractor must exclude unallowable costs, as defined in FAR 31 and specific contract terms. Most contractors set up unallowable cost accounts in their general ledgers and identify each cost separately at the document-processing and review-and-approval steps. Accounting personnel must become knowledgeable of FAR 31 cost principles and auditors will need to make sure the contractor has a plan to identify and exclude unallowable costs. (*A written policy and procedure on treating unallowable costs is considered essential.*)

*Other Considerations.* To properly segregate costs, manufacturing contractors must have a system in place that can segregate preproduction costs to assist in re-pricing or follow-on contract pricing in order to ensure that preproduction costs are not paid twice. To meet *funding limitation* requirements common in cost reimbursable and T&M contracts, auditors will ask how often they are reviewed, what controls are in place to notify that FAR limitations are approaching, do contractors prepare abstracts of contracts and is a person assigned to be in charge of comparing costs accumulated to date on a contract to the cost or funding limitation so appropriate notifications requirements are met. For *interim billings*, contractors must prepare interim billings of direct costs directly from the books and records (*rather than relying on gathering necessary documents, often rushed, during billing periods.*). Costs of items purchased directly for the cost type contract may be claimed only if the costs will be paid according to the terms of the subcontract or PO (*recognition of a bona fide cost that is reported in accordance with the contractor's recognition of an incurred cost can be substituted*). The auditor will take a sample of bills submitted and trace them to the job-cost ledgers and provisional billing rate letters for indirect costs. These tests will be made for both current and cumulative costs so records should show that the current and cumulative costs are accrued. (*DCAA has recently been emphasizing the need to use statistical sampling techniques to state a practice is acceptable so you can expect increased transaction testing.*) For *pricing follow-on work*, costs should be segregated by lots and engineering costs must be segregated from manufacturing costs so that a learning curve (i.e. unit costs reduced based on higher volume) can be computed and applied to pricing follow-on work.

Finally the auditor will ascertain whether the accounting system is currently in full operation. Because they do primarily government fixed price or commercial work, contractors may not have the system up and running when audited. If so, the auditor must report though the system is set up, it is not yet in operation. If this is the case, the auditor will usually indicate the system is acceptable for award of a prospective contract but that a follow-on accounting system review be performed after contract award. The author says he advises contractors to create adequate systems using data from their fixed price or commercial work just to demonstrate the system does everything it is supposed to. (*Editor's Note. In our experience, auditors these days will not indicate the system is acceptable for award without having at least 90 days of cost data generated from an adequate accounting system.*)

## RESPONDING TO DCAA CONCERNS OVER INDIRECT RATE CHANGES

*(Editor's Note. In the 4Q10 issue of the DIGEST we described a case study where we helped a client significantly revise its indirect rate structure. This article is a follow up where we respond to certain DCAA concerns over the changes. We thought it would be a good idea to include the dialogue with DCAA because it illustrates many of the issues our subscribers need to focus on when either defending their selected indirect rate structure or considering a change.)*

As background information the changes we recommended are summarized as:

1. Creating two segments, one for commercial products (CS) and one for government services (GS).
2. Creating a home office where costs were accumulated and allocated to the two segments. Since the commercial segment was new where there were very little costs, the client established an agreement of a set amount of costs used to allocate home office support costs.
3. In the government segment, substituting two overhead rates for one rate. The change was motivated to help achieve our client's pricing objectives after it realized that certain contracts were highly price sensitive requiring minimal costs in the one overhead pool they were housed while other contracts were less price sensitive where we wanted to maximize costs in the pool those contracts lived and still comply with government accounting rules.
4. We created several cost centers that allocated costs to the two overhead pools, home office and other cost centers. These included IT services, facilities costs and accounting/finance allocated on basically headcount allocation bases. Contract/subcontract management services were allocated to the overhead pools based on the number of contracts and subcontracts worked on using a weighted average of 4 to 1 for contracts versus subcontracts because managing contracts required four times more effort than managing subcontracts.

Happily, DCAA did not challenge the changes to the structure but did raise concerns over some of the allocation methods used where they invited our response. These concerns and an edited version of our response is included below:

### Our Response

#### ◆ Allocation of Accounting and Finance

DCAA believes that the allocation of finance and accounting center costs should be from GS's G&A pool not overhead. The reason stated is that the auditor has not seen it done in other ways based on his prior experience. They also questioned using a headcount base.

*Overhead rather than G&A.* The majority of tasks of our finance and accounting functions are really driven by our company's personnel needs and contract activity. Most accounting and finance people spend their time either directly on personnel related functions (timekeeping, payroll, benefits), job cost accounting- related functions or supervising these functions. Consequently, we believe those costs more properly belong in overhead, which is oriented to indirect support of projects, rather than G&A which is related to running the business as a whole. Since these functions support primarily personnel or direct labor projects we believe a headcount base provides the best surrogate measurement of labor driven costs because it (1) it is a simple and accurate metric to maintain and (2) closely reflects labor related costs.

*Why not G&A.* If the costs were included in GS's G&A pool we believe the costs would not meet the causal and beneficial test of allocation to final cost objectives. First, some finance and accounting costs do, in fact, benefit the company's commercial segment. Inclusion of all accounting and finance in GS's G&A pool precludes this allocation. Second, since it supports primarily labor activity, the best base would be one that measures labor activity only as opposed to the total costs in the G&A base which would be required if those costs were in our G&A pool. Third, our G&A costs are those that benefit the company as a whole as distinct from benefitting company projects. As we have shown above, the majority of activity in the accounting and finance cost center benefit projects more than the company as a whole.

#### ◆ Contracting and Subcontracting Costs

DCAA has raised two issues related to allocating our contracts and subcontracts cost center: (1) the basis for assuming administration of contracts takes four times the effort than subcontracts and (2) why are these costs not allocated directly to specific projects.

*Justification for the 4 to 1 ratio of effort related to administering contracts and subcontracts.* We have considered various

ways of allocating these costs. Dollar value of both contracts and subcontracts was considered but dismissed because tasks and costs required for administering contracts were significantly higher than those required to administer subcontracts. As a result, using a dollar value base would result in allocating an inequitably large amount of costs to subcontracts and an inequitably small value to contracts. We conducted an analysis (we provided a detail description of tasks required for contracts compared to subcontracts not shown here) and concluded there was a 4 to 1 ratio of effort between contract and subcontract effort. Hence we weighted contracts four times higher than subcontracts and then allocated the costs to overhead pools on this weighted average number of contracts and subcontracts.

*Why not direct allocation.* Like most companies, we have long considered contract and subcontract management and administration a company function rather than a direct contract function. In addition, to allocate costs directly to specific final costs objectives presupposes such identification of costs can be done without excessive administrative burden. This condition is not met at GS because most contract and subcontract administration activities occur for multiple final cost objectives where identification of one is not readily practical.

#### ◆ Home Office Allocation Base

DCAA has raised the issue of using other bases to allocate home office costs such as direct labor or total cost input than agreeing to allocate a set amount of costs to CS.

*Use of a direct labor base to allocate home office costs.* Unlike the GS segment, where projects are primarily labor driven, most projects in the CS segment are expected to incur a low labor component cost and high subcontract and material cost component. As a result, use of a direct labor base will tend to overallocate home office costs to the GS segment and its government contracts and underallocate costs to CS and its commercial work.

*Use of a total cost input base to allocate home office costs.* At this time, use of a TCI base would result in a significant under-allocation of costs to the CS segment since there is so little costs incurred at this time. The current agreement method results in allocating HO costs to GS versus CS on a ratio of 75 to 25. If a cost based approach was used, whether direct labor or TCI, there would be little to no allocation to CS. We believe the

current method benefits the government and contributes to our desire to offer the lowest possible cost based prices to the government. In the future, when presumably CS will generate revenue and corresponding costs, we intend to move toward a total cost input base to allocate residual home office costs. For now, we will continue using a 75/25 split and will conduct a cost impact analysis to see whether the government continues to benefit.

## Knowing Your Cost Principles and Cost Accounting Standards...

### BASICS OF THE COST ACCOUNTING STANDARDS

*(Editor's Note. We find most of our subscribers enjoy our in-depth articles on a single FAR cost principle or cost accounting standard. Many of our clients and subscribers believe they are currently or will soon have certain contracts covered by some or all of the cost accounting standards (CAS) where rather than reading detailed descriptions of each principle or standard, have asked for a short summary of the important aspects of the CAS so here it is. The following is intended to simplify the CAS so those contractors not acquainted with CAS can learn the basic fundamentals, determine their CAS status and obligations and establish the basis to learn more. Our source of information is a multitude of articles and texts we have both read and written over the years.)*

The Cost Accounting Standards are a group of accounting rules that dictate how the costs of government contractors are measured, accumulated, assigned to years and allocated to contracts. The CAS and its regulations and interpretations are issued by the CAS Board – an authorized, independent five-member board within the Office of Federal Procurement Policy. As originally promulgated in the early 1970s, CAS applied only to Department of Defense contracts where in 1988 the statute underlying the CAS was extended to apply CAS to all negotiated civilian agency contracts and then in 1995 was further extended to cover educational institutions.

### CAS Applicability

Technically, contracts or subcontracts, not contractors, are covered by CAS though in practice, if a contract becomes CAS covered then the contractor needs to implement accounting practices that are compliant with the standards. So you will usually hear that contractors are or are not CAS covered where we will use that shorthand designation.

There are two steps in determining whether you are CAS covered: does one of the exemptions apply and if not, what is the level of coverage.

### ◆ Exemptions

The CAS covers all contracts and subcontracts unless a specific exemption applies. Contract modifications are exempt or nonexempt from CAS coverage based on whether the contract under which it was issued is exempt or not. (*Unless we specify it, whenever we mention contracts or contractors it will also apply to subcontracts and subcontractors.*) There are 10 exemptions, the principle ones being (1) sealed bid contracts (2) negotiated contracts not in excess of \$750,000 (3) contracts with small businesses (4) contracts where prices are set by law or regulations (5) contracts for commercial items and (6) firm-fixed price contracts awarded without submission of any cost data. In addition, one of the exemptions, contracts performed overseas, has recently been eliminated. A contract may very well be subject to CAS coverage even though the procurement was exempt from the Truth in Negotiations Act covering certified cost or pricing data because CAS coverage occurs when cost data is submitted whether or not it is “certified”.

### ◆ Level of Coverage

There are two types of coverage: “full” coverage by all 19 standards or “modified” coverage by four standards.

*Full coverage.* Full CAS coverage applies to a contractor’s business unit that (a) receives a single CAS-covered contract of \$50 million or more (the threshold mentioned in this article will likely change more often than in the past since the CAS Board has expressed the desire to keep up with inflation) or (b) received \$50 million or more in “net CAS covered awards” (which includes the potential value of contract options) during the preceding cost accounting period provided that a “trigger” contract exceeding \$7.5 million was first let.

*Modified coverage.* If a nonexempt contract is for less than \$50 million but more than \$7.5 million and the business unit received less than \$50 million in net awards the previous cost accounting period, four of the standards apply: CAS 401, CAS 402, CAS 405 and CAS 406. Once a contract with modified coverage is awarded to a business segment in a cost accounting period, all that business unit’s nonexempt contracts for the period are also modified covered

unless a fully CAS covered award is made. A subsequent contract award over \$750K will be either fully or modified CAS covered depending on the coverage of its prior contracts.

In this age of new contract vehicles where an “umbrella” contract (e.g. ID/IQ) forms the basis to provide numerous orders it is confusing whether the thresholds apply at the contract level or individual task or delivery order level. Basically unless the umbrella contract clearly identifies a dollar level (unusual these days) the threshold applies at the task/delivery order level.

### Disclosure Statement

The CAS Disclosure statement is an 8 section form that asks the contractor to describe their accounting practices in some detail. The CAS Board occasionally issues revised forms so make sure you have the latest.

The threshold for the responsibility of issuing a disclosure statement is similar for full coverage – either before a \$50 million dollar contract is awarded or if \$50 million in CAS-covered contracts were awarded in the preceding cost accounting period (provided the \$7.5 million trigger contract is exceeded). The \$50 million dollar threshold for the second condition is measured by the aggregate of all contracts awarded to all segments of a company in the preceding cost accounting period. A contractor that meets these thresholds must submit a disclosure statement either before the \$50 million threshold is met or before award of its first CAS covered contract in the immediately following accounting period. If one of the business units of a corporate family receives a CAS covered contract then any other business unit that receives a \$750,000 contract to which modified CAS coverage applies must also file a disclosure statement (whether that contract is a stand-alone or is an intercompany transfer of costs to another contract.)

### Administrative Considerations

Various contract clauses impose a variety of requirements. In addition to imposing requirements to disclose practices and comply with all standards, the clauses applicable to either full or modified coverage address adjustments to contract prices if a change to an accounting practice occurs, requiring cost impact analyses which are the most onerous aspects of being CAS covered.

## Individual Standards

There are 19 individual standards – CAS 401 through CAS 418 and CAS 420, no CAS 419. They are codified in the CFR at 9904.

1. CAS 401, Consistency in Estimating, Accumulating and Reporting Costs. This standard is the first that embodies a theme of consistency. Here, CAS 401 requires a contractor's practices used in estimating costs for a proposal be consistent with its practice used to accumulate and report costs. Conversely, the contractor's cost accounting practices to accumulate and report its costs must be consistent with practices used to estimate costs.

2. CAS 402, Consistency in Allocating Costs Incurred for the Same Purpose. This is another consistency standard where CAS 402 provides that all costs incurred for the same purpose "under like circumstances" are "either direct only or indirect costs only." A direct cost is identified specifically with a final cost objective (e.g. contract, task or delivery order, grant) while an indirect costs is a cost identified with two or more final cost objectives. So, if a type of cost is a direct cost on a contract the same type of costs cannot be treated indirectly on another contract if the costs are incurred "in like circumstances." As an illustration, the CAS Board stated that bid and proposal costs that are treated as indirect costs may be charged direct if the proposal was required by contract because the circumstances in the latter case were unlike submission of proposals under other cases. Contractors should explain in the proposal the manner in which costs are treated in "unlike circumstances" or if the circumstances are not "unlike" then why the apparently similar costs are not similar.

3. CAS 403, Allocation of Home Office Overhead to Segments. CAS governs the allocation of home office and intermediate home office expenses to contractor segments. A "segment" generally means a division, plant or department with separate reporting and usually profit center status where it need not necessarily be a separate "legal" entity. The home office or intermediate home office may be responsible for managing two or more segments but not necessarily all segments. CAS 403 provides a hierarchy of three ways to allocate home office costs to segments: (1) directly to a particular segment (2) indirectly to two or more but not necessarily all segments where the manner of allocation must reflect a "logical relationship" between the cost and benefit

received (e.g. personnel management allocated over a labor related base) and (3) remaining costs, called residual costs, to all segments. The residual pool may be allocated to segments based on a measurement of total activity where if it exceeds \$3.35 million, the base of allocation must be the three factor formula (average percentage of segments' payroll, operation revenue and net book values of assets).

4. CAS 404, Capitalization of Tangible Assets. CAS 404 requires contractors to (a) capitalize all assets with both a useful life of two years or more and a cost of more than \$5,000 and (b) develop criteria for determining the life of an asset. When an asset is capitalized, its costs are depreciated and only the depreciation for that year may be charged in that year. Costs that extend the life of an asset must be capitalized with the asset but if it restores or maintains the life of an asset it is to be expensed to the current period. In recent times the CAS (and FAR) have been amended to reflect asset values during a business combination where the asset cannot be valued at greater amounts than those recorded by the seller, regardless of what the purchase price was.

5. CAS 405, Accounting for Unallowable Costs. CAS 405 provides that expressly unallowable costs and those agreed by the government and contractor to be unallowable must be identified and excluded from any billings, claims or proposals applicable to government contracts. Such unallowable costs must also bear their fair share of applicable general and administrative costs (must be included in the G&A base). The same rules apply to "directly associated costs" – they would not have been incurred had not the unallowable costs been incurred.

6. CAS 406, Cost Accounting Period. CAS 406 generally requires contractors to use their fiscal year as their accounting period but permits use of other annual periods if they are more representative of costs and the government agrees. There is also a consistency provision that except for narrow exceptions requires use of the same accounting period for accumulating costs, establishing allocation bases and allocating costs.

7. CAS 407, Standard Costs for Direct Material and Direct Labor. CAS 407 applies only to standard costs which is a cost computed by using one or more pre-established measures. It is not an actual cost so amounts that are later incurred that are not projected in the standard cost is a variance. If a contractor wants to use standard costs, it must establish, in writing, how

standards are set, revised, used and how variances are treated. Standard costs are normally booked where they and variances are accounted for at the level where they were consumed (called the “production unit”) and variances must be disposed of at least annually.

8. CAS 408, Accounting for Costs of Compensated Personal Absence. The standard defines compensated personal absence as “any absence from work due to reasons such as illness, vacation, holidays, jury duty, military training or personal activities for which an employer pays compensation in accordance with its plan or custom.” CAS 408 requires these costs be assigned to the period they were “earned” (i.e. when the contractor becomes liable for it) and a prorate share be allocated to cost objectives. If compensation is payable only under certain occurrences (e.g. sick leave earned but not if terminated) then it must be assigned only to the period in which it was paid.

9. CAS 409, Depreciation of Tangible Capital Assets. This sister provision to CAS 404 requires the capitalized cost of the asset, minus residual value, be amortized over the service life of the asset. CAS 409 generally likes the allocation of depreciation be through indirect cost pools. A gain or loss on the disposition of an asset must be assigned to the period of the disposition and allocated in the same manner the depreciation costs were made.

10. CAS 410, Allocation of Business Unit’s General and Administrative Expenses to Final Cost Objectives. G&A costs are those expenses incurred for the management of the business as a whole. CAS 410 requires them to be accumulated in a separate pool and allocated to final cost objectives by means of cost input bases representing total business activity. CAS 410 recognizes three acceptable allocation bases: (1) total cost input (TCI), which is generally accepted, consisting of all costs except for G&A expenses (2) value added which is TCI minus material and subcontract costs or (3) single element base (most commonly direct labor dollar base), which is rare. G&A expenses are allocated during the year by means of a predictive rate established at the beginning of the year with adjustments for actuals at the end of the period. Also, CAS 410 provides for special allocations which entails a different G&A expense allocation to cost objectives that receive significantly more or less benefit from the G&A expenses.

11. CAS 411, Accounting for Acquisition Costs of Material. The acquisition costs generally include its price adjusted for rebates or discounts. The standard

contains detailed rules for costing material in company-owned inventory and for allocating those costs through methods (e.g. FIFO, LIFO).

12. CAS 412, Composition and Measurement of Pension Cost. CAS 412 governs the determination and measurement of pension costs and recognizes three basic types, each of which are treated differently – defined benefit, defined contribution or pay-as-you go. Pension costs for defined benefit basically consists of (a) normal cost (present value of future benefits) (b) a portion of unfunded actuarial liability (where value of assets are lower than actuarial liability and interest) and (c) adjustments for actuarial gains and losses (where actuarial assumptions differ from experience). Pension costs for defined contribution plans represent costs an employer is required to make to the plan for the period while costs for defined pay-as-you go plans are amounts paid to retirees (and their beneficiaries) for benefits in the period plus amortization installments on amount paid to settle future benefits. Generally, only pension costs that are funded by the date for filing corporate taxes can be recovered where if not funded, cannot be recovered currently or in the future.

13. CAS 413, Adjustment and Allocation of Pension Cost. This sister standard to CAS 412 covers adjustment of pension cost for actuarial gains and losses and allocation of pensions to segments. It requires that actuarial gains and losses be calculated annually, amortized and assigned to the current and future period in installments. As for allocation to segments, a composite rate is normally permissible but a segment’s pension costs must be separately calculated where (a) there is a material termination of employment in the segment (b) the segment’s benefit level or eligibility differs significantly from other segments or (c) the segments actuarial assumptions differ from other segments. In addition, the standard requires adjustments when either plan benefits or the contractor’s business with the government changed. If a segment is closed, which can occur also when a segment no longer seeks government business, a plan is terminated or benefits are changed the difference between market value of the assets and actuarial liability represents an adjustment to prior pension costs where the adjustment can favor either the government or contractor.

14. CAS 414, Cost of Money as an Element of the Cost of Facilities Capital. The facilities capital cost of money (FCCM) is a rate, based on interest rates set every six months by the Dept. of Treasury,

multiplied by the net book value of tangible capital assets and intangible amortized capital assets (including land). The resulting amount is allocated to cost pools where a separate FCCM factor is determined for each indirect cost pool to which a significant amount of facilities capital has been allocated. CAS 414 provides a form and example (CASB-CMF) for calculating these amounts.

15. CAS 415, Accounting for the Cost of Deferred Compensation. Deferred compensation is defined as an award made by an employer to compensate an employee in a future accounting period for services rendered in a period prior to the payout. The cost of the deferred compensation is the present value of the future payment. CAS 415 requires contractors to assign the compensation to the period in which the obligation to pay compensation becomes fixed, not in the future period it is paid. The standard prescribes a six part test for determining whether an obligation is established where basically the test is (a) if a payment (which must be made in cash, assets or stock to a known individual) cannot be voided by the employer (b) the future award is reasonably measurable and (c) occurrence of a precondition for payment is reasonably probable.

16. CAS 416, Accounting for Insurance Costs. This standard governs the measurement, assignment and allocation of insurance costs. The standard's concept of insurance costs is "projected average loss" – the estimated long term average loss per period. If insurance is purchased, the projected average loss is presumed to be equal to the amount of insurance premiums. For self-insurance, projected average loss (plus administrative expenses) is the amount to be charged to a period, not the actual loss for that period.

17. CAS 417, Cost of Money as an Element of the Cost of Capital Assets Under Construction. Unlike its FCCM sister in CAS 414, the cost of money is recovered by being part of the capitalized cost of the asset. COM is a rate, based on Treasury interest rates set every six months, multiplied by the "representative investment amount" of assets under construction. The standard is rather vague on how to compute this amount but generally GAAP accounting is acceptable.

18. CAS 418, Allocation of Direct and Indirect Costs. This standard addresses how to determine if a cost is direct or indirect, the coherent pooling of indirect costs and the allocation of indirect costs to cost objectives. CAS 418 requires business units to

establish and consistently apply policies for classifying costs as direct or indirect. It also requires indirect costs be accumulated in "homogeneous" cost pools (where cost elements are similar and their relationship to direct costs are similar). Pooled costs must be allocated to cost objectives based on "beneficial or causal relationships." General guidelines and numerous examples of appropriate activity bases are provided but they are only suggestive, not required, so in practice there is a great deal of flexibility here. Also, a special allocation is permitted unlike a mandatory special allocation provision in CAS 410.

20. CAS 420, Accounting for Independent Research and Development (IR&D) Costs and Bid and Proposal (B&P) Costs. This standard governs the determination and allocation of IR&D/B&P costs where basically if IR&D costs are not sponsored by a grant nor required in the performance of a contract it can be considered indirect IR&D while if sponsored or required, it must be considered direct. IR&D/B&P costs of a business unit are allocated over the same base used for allocating G&A costs (usually included in the G&A pool). IR&D/B&P costs accumulated at the home office must be distributed directly to its benefiting segments where after the direct allocation, all remaining IR&D/B&P costs remaining at the home office may be included in the residual cost pool. Like CAS 418, special allocations of IR&D/B&P costs are permitted.

## LEVERAGING THE HR FUNCTION

*(Editor's Note. Though we are usually focused on the cost and pricing aspects of complying with government requirements, we are frequently reminded how other functions within a company need to be "on board" to successfully do business with the federal government, especially when they do something wrong. We were glad to come across an article in the Nov. 2008 issue of the Briefing Papers by Andrew Iwin and Julia Ryan of Steptoe & Johnson that addresses the Human Resources function in making sure a government contractor is compliant with government imposed rules. We were particularly glad to get a review of various compliance rules and laws since they have been amended in recent times. Feel free to copy this and distribute to people involved in the HR function as well as related functions such as contracts administration, project management, etc.)*

There are a range of issues Human Resources is responsible for or at least needs to be mindful about. In addition to orienting the new employee to general



codes of conduct and ensuring tax and benefit information is conveyed and forms completed, the HR department needs to set the tone for the unique requirements of government contractors discussed below since they are the day-to-day contact with employees.

## Hiring Government Employees

While there are undoubtedly many advantages for hiring former federal government employees there are many pitfalls and traps for hiring such employees. Since these pitfalls are receiving increased attention from politicians and the media these days, the HR staff needs to be mindful of the basic laws and regulations affecting contractors' ability to hire government employees. (The authors stress their article provides only a basic introduction to these more important laws and regulations so they should not be considered a substitute for more intensive study.)

### ◆ Procurement Integrity Act

The PIA restricts the ability of contractors to "compensate" former government employees who leave the government to work in the private sector as well as restricting certain employee discussions. To be covered by the PIA, the government employee needs to have been involved in a procurement process that relates to the contractor. HR personnel should consider these PIA restrictions when reviewing resumes or in advising other employees about contacts with current or former government employees.

Though quite detailed, the basics of the PIA is any government official who is participating personally and substantially in a federal procurement in excess of \$100,000 and is contacted by a bidder or offeror regarding employment that official must (a) promptly report contact in writing to his supervisor and to the agency's designated ethics officer and (b) either reject employment or disqualify him or herself from further personal or substantial participation in the procurement. The Act also bans designated agency officials involved in a procurement over \$10 million from accepting compensation from the contractor for one year. Officials subject to the ban include (1) the procurement contracting officer, source selection authority, member of a source selection evaluation board and the chief of a financial or technical evaluation team (2) the program or deputy program manager or ACO for a contract (3) any official who personally made a decision for the agency with respect to award of a subcontract, contract, mod or task/

delivery order exceeding \$10 million, established overhead or other rates applicable to the contracts, approved contract payments in excess of \$10 million or paid or settled a claim exceeding \$10 million. The compensation restriction does not apply if the employee is hired by a division or affiliate of the contractor that does not produce the same or similar products or services as the entity of the contractor responsible for the contract in the procurement to which the government employee was involved.

### ◆ 18 U.S.C.A # 207 – Postemployment Restrictions

Part of the US federal criminal code imposes post-employment restrictions on former officers, employees and elected officials of the executive and legislative branches. Among other things, it imposes a lifetime ban on former government employees communicating with or making an appearance before the government in a private sector capacity with respect to a "particular matter" involving a "specific party or parties" in which they participated personally and substantially while in government. The statute also contains a two year restriction on representing a contractor with respect to matters that were under an employee's "official responsibilities" while with the government. It also contains various additional restrictions for senior level government employees, members of Congress or their staff (too detailed to recount here). The restrictions do not prevent the employee from being hired only restricts what the former employee can or cannot do in the course of their employment. "Behind the scenes assistance" is not forbidden.

### ◆ 18 U.S.C.A. # 208-Acts Affecting Personal Financial Interest

This other criminal statute deals with conflicts of interest when someone seeking employment is still in the government. Even if PIA or section 209 above is not violated there are still potential violations of Section 208 where you need to be mindful that government employees seeking employment with a contractor must typically recuse themselves from actions that might affect the interest of the organization where they are seeking employment (and hence financial gain).

Both Sections 207 and 208 have considerable activities that might constitute seeking employment which are too detailed to discuss here so the authors recommend professional HR managers and legal staff become

familiar with these rules. They recommend companies develop a monitoring program for resumes where such a program might have a kind of decision tree function. For example, a series of questions might include “Is this person a current government official?” “Do they work at an agency we do business with?” “Has this person been involved in procurements?”

## Gifts & Gratuities

This is an especially problematic area for employees with a commercial background where providing goodies to current and prospective clients is a normal way of conducting business where such activities are rarely called into question. HR personnel can provide an important role in addressing risks of accepting gifts and gratuities since HR is usually the function that provides training in this area. In addition to the FAR, Subpart 3.2 and 52.203-3 the following address this topic:

### ◆ 18 U.S.C.A. # 201 – Bribery and Gratuities Statute

This statute makes it a crime to provide something of value, which is broadly defined and not limited to cash, to a federal official in exchange for an official act. The statute has both a bribery and gratuities component where the bribery component requires corrupt intent whereas the gratuities component does not. The bottom line for HR professionals is to let employees know that giving gifts, entertainment or other things of value to US government officials can have negative consequences for the government official, company and individual involved. You need to be particularly sensitive to risks posed by employees recruited from the private sector where normal and acceptable behavior is not proper in the government contracting arena.

### ◆ OGE Gift Rules

The US Office of Government Ethics includes the Standards of Ethical Conduct for Employees of the Executive Branch where though it applies to government, not contract employees, still needs to be aware since action inconsistent with the Standards might result in the government employee facing disciplinary action. To the extent to which a contractor is a “prohibited source” (e.g. a concern doing or seeking business with a Government agency) the employee is prohibited from soliciting or accepting gifts from the contractor.

As we have reported in the past (GCA REPORT, Sep/Oct 2004), there are several exceptions in the Code of Federal Regulations (2635.203(b), 2635.204) including nine stated categories of things that are “not a gift” such as modest refreshments at a meeting like coffee and donuts that are “incidental” to a meal, things of little intrinsic value (a pencil bearing a contractor’s logo), gifts for which market value was paid (e.g. meal, movie ticket), etc. In addition, there are 21 other stated exceptions where the most common ones include: (a) the organization-wide “20/50 rule” – value of the gift is less than \$20 and limited to \$50 in a year given to an organization as opposed to an individual (b) widely attended rule where an employee may accept free attendance at a meeting if five criteria are met (e.g. large number of attendees – 20 – will attend, a diversity of views or interests will be present, attendance will advance agency programs or capabilities) (c) gifts are based on personal relationships, etc.

### ◆ Anti-Kickback Act

In addition to gift rules relating to interactions between prime contractors and the US government there is a separate criminal statute, the Anti-Kickback Act of 1986, that makes it illegal for a lower-tier contractor to offer or give something of value to a prime contractor in exchange for improper treatment under a prime contract. It is also illegal for the prime contractor to solicit or receive anything in exchange for improper treatment under a federal subcontract. So the HR professionals need to understand they are not only restricted in law in their dealings with the government but also, under the Anti-Kickback Act, are covered in their seemingly commercial interactions with subcontractors.

### ◆ Foreign Corrupt Practices Act

Many contractors operate abroad both in their commercial business and increasingly in their dealings with the US or foreign governments. Though HR personnel may not be particularly familiar with the FCPA by name, they are more than likely familiar with some of the concepts. The FCPA’s anti-bribery provisions say that an entity should not give or offer anything of value to a foreign public official to obtain or retain business or to secure an improper advantage. The term “foreign official” has a broad meaning where it includes representatives of state-owned entities, members of royal families, political parties, or employees of public international organizations. Violations of the FCPA can occur directly or through third-party intermediaries such as sales agents.

Government contractors should be aware that even if their customer is a commercial entity the FCPA may still be implicated when, for example, arrangements may involve dealings with foreign customs, tax and immigration officials.

An HR professional needs to become conversant in the FCPA because (1) it is involved in new employee orientation (2) employees in the field may ask questions about apparent local customs that can be a FCPA risk or (3) if you are involved in reviewing expense reports you may uncover improper payments. Finally, most foreign countries have their own antibribery and anticorruption rules so activities prohibited by the FCPA will likely be illegal under local law so a company may be vulnerable to both sets of laws.

## Immigration

Immigration rules are becoming an increasing area of government compliance where HR usually plays a central role so HR professionals need to be aware of new rules. If HR fails to take proper steps and hires illegal aliens there is increasingly the possibility of suspensions and even debarment actions.

## AVOIDING COST BASED PRICING

*(Editor's Note. Recent changes to the FAR, guidelines submitted by the Defense Department and experience of our clients and subscribers strongly indicate that contracting officers are increasingly asking contractors to provide cost data to justify that prices being awarded are reasonable. One of our clients is about to submit a large proposal where a large part of the proposal represents equipment that will be provided by an affiliated subsidiary of its company where they want to charge the equipment at market based prices as opposed to having the price be based on an estimated cost buildup. The client asked us to provide a brief memo on the rules covering this issue. There are several conditions that will allow such treatment such as showing there is adequate competition for the equipment and the equipment qualifies as a commercial item. The following is an edited version of our response and we have disguised both the name of the company and equipment.)*

After thinking about your needs, I decided to focus this memo on how Subsidiary A can transfer equipment to a contract under Subsidiary B at a price not based on cost buildup estimates. To this end, there are three basic components I am including here: (1) What does the FAR explicitly say about intercompany transfers of goods and services (2) Does the Truth in

Negotiations Act (TINA) provide any useful guidelines since it addresses cost based pricing and (3) What is a commercial item.

## Federal Acquisition Regulation

FAR 31.205-26, Material costs addresses the methodology for intercompany transfers of goods and services between business segments. Section (e) provides the price of the item being transferred will be on a cost buildup estimate so here the transferring segment may transfer the item to the receiving segment at fully burdened costs i.e. all direct and indirect costs. Profit can be added only once so either the transferring or receiving segment may add profit, not both.

However, cost based transfers from segments catering to the commercial sector created problems for segments unable or unwilling to provide cost based pricing. In recognition of this problem, the next part of that section provides an exception for cost transfers. A price, as opposed to incurred costs, may be used when it is the established practice of the transferring organization to price inter-organizational transfers at other than cost for commercial work of the contractor and the item being transferred qualifies for an exception under FAR 15.403-1(b). This section refers to the item being transferred as a commercial item and states the price rather than cost may be used (1) when the government has not determined the price being transferred is unreasonable and (2) the price used is based on a catalog or market price. This catalog or market based price must be adjusted to reflect quantities being acquired or the price may be adjusted to reflect actual costs of any modifications necessary to meet contract requirements. So the lesson here, is if we can convince the government that the transferred item is either a commercial item or at least there is a catalog or market based price for the item and the resulting price is "reasonable" then the FAR provides for a transfer price not based on a cost buildup.

## TINA Exceptions

Historically, the Truth in Negotiations Act (TINA) generally required contractors doing business with the Government to submit certified cost or pricing data prior to award of a negotiated prime contract, subcontract at any tier, or modification of a prime contract or subcontract expected to exceed certain dollar thresholds (currently \$750,000).

TINA recognized three general exceptions from its data requirements: (1) if contract prices were based on adequate price competition (discussed in the last

DIGEST issue) (2) catalog or market prices of commercial items sold in substantial quantities to the general public or (3) prices set by law or regulation. In addition the head of a contracting activity may waive the requirement for submission of cost or pricing data. There are lots of examples of such waivers being granted where, for example, a commercial firm simply refuses to do so and the desire for the item outweighs insisting on following the rules to a T. If you go the waiver route, make sure you can help the agency granting the waiver show that the price paid is reasonable.

## Commercial Item

### ◆ Definition

FAR 2.101 provides the basic definition of “commercial item” where highlights include “any item, other than real property, that is of a type customarily used for non-government purposes and that (1) has been sold, leased or licensed to the general public; or (2) has been offered for sales, lease or license to the general public”. Thus an item need not be actually sold to the general public but only been *offered* for sale. An item not yet available commercially may also qualify as a commercial item if it has evolved from an existing non-commercial item through advances in technology or performance and will be available in the commercial marketplace in time to satisfy delivery requirements under a Government solicitation. Also, if a commercial item has been modified, it still constitutes a commercial item if the modification is of a type “customarily available in the commercial marketplace.” In addition, an item’s identification as a commercial item will not be lost

through *minor* modifications of a type not customarily available in the commercial marketplace if they are needed to meet government requirements. A modification is “minor” if it does not significantly alter the non-governmental function or essential physical characteristics of an item or change the purpose of a process.

After considering the alternatives available to avoid provision of cost data, I think your best bet is to establish the equipment as “commercial items.” Short of that, then the next best bet is to establish an adequate competition between your subsidiary and one (hopefully two) other firms. If that fails seek a waiver where if you want to take the “take it or leave it approach” then help the agency head who takes it establish a justification to conclude the resulting price being paid is reasonable (e.g. the equipment or all major component parts are based on market-based prices.)

## INDEX

Oldie but Goodie...	
DCAA AUDITOR IDENTIFIES HOW HE WOULD CONDUCT AN ACCOUNTING SYSTEM REVIEW .....	1
RESPONDING TO DCAA CONCERNS OVER INDIRECT RATE CHANGES .....	3
BASICS OF THE COST ACCOUNTING STANDARDS .....	4
LEVERAGING THE HR FUNCTION .....	8
AVOIDING COST BASED PRICING .....	11