

Strategies for Compliant Government Cost Accounting

For Small and Emerging Companies

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What are we going to discuss?

- Understanding the Importance of Consistency
- Understanding Direct and Indirect Costs
- Defining an Indirect Rate Structure
- Establishing a Chart of Accounts
- Consistency in Recording Costs
- Developing Proper Labor Recording Practices
- Recognizing Unallowable Costs
- Developing Policies and Procedures

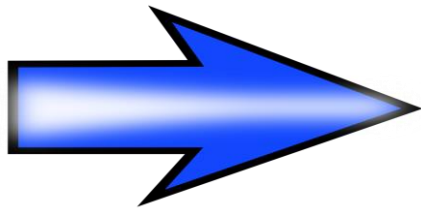
Importance of Consistency

CAS 401, Consistency in Estimating, Accumulating and Reporting Costs

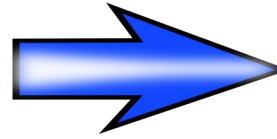
FAR 31.201-1, Composition of Total Cost and FAR 31.203, Indirect Costs

- Contractor practices used in estimating costs in pricing proposals must be **consistent** with practices used in accumulating actual costs
- Contractor practices used in accumulating costs must be **consistent** with practices used to estimate costs in pricing related proposals
- Costs may be accumulated in **GREATER** detail than estimated or proposed, but not estimated or proposed, in **GREATER** detail than accumulated

Understanding Direct and Indirect Costs



Direct costs... (FAR 31.202)



- Those costs that can be identified specifically with a particular contract, customer order or final cost objective
- “But for” cost – would not be incurred “but for” the existence of a specific contract or final cost objective
- **Anticipated to be recoverable from the customer as a specific contract item**
- **Basis for allocation of indirect costs to cost objectives**

And Indirect costs...

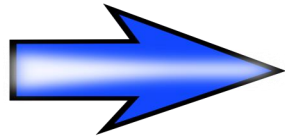
(FAR 31.203)



- Incurred for the common good of the organization or its employees
- Benefits more than one contract, customer order or final cost objective
- Cannot be specifically identified to a particular cost objective
- **Not recognized by your customers as a specifically deliverable contract item**

And Other Direct Costs (ODC's)...

- Direct items generally not defined in the contract SOW
- In addition to direct labor and material
 - Includes such items as: airfares, lodging and subsistence, mileage, relocation costs, schooling tuition allowances, shipping costs, freight costs, storage fees, security clearances, etc.



Direct or Indirect



CAS 402 / FAR 31.203

- Costs incurred for the same purpose, in like circumstances must be either direct or indirect
- **Must be treated consistently**
- **Can not be both**

Defining an Indirect Rate Structure

Why? What is the purpose?

- Allocate associated indirect costs
- Determine actual product or service costs
- Assist in management decision making process
- Maximize cost recovery
- Ensure consistent compliance



Indirect Rate Calculation

Homogeneous Cost Pool (Indirect Costs)

= Indirect Rate %

Cost Allocation Base (Direct Costs and Allocated Indirect Costs)

Homogeneous cost pools...

- Costs included in the pool must have a similar beneficial causal relationship to cost objectives
- Allocation can not be materially different than if the costs were allocated separately
- Shall include all of the homogeneous indirect costs identified with the activity to which the pool relates

Cost allocation base...

- Best suited for assigning the particular expense pool to the cost objective (contract, customer order, product or service line, etc.)
- Must have a cause and effect relationship to the expense pool being allocated
- Must produce equitable results to all parties involved
- Must include all expenses (allowable or unallowable)

Types of Indirect Rates...

- **Budget Rates** (approved internally for management purposes and as a basis for pricing products and/or services)
- **Pricing Rates** (Forward Pricing Rates, negotiated contract rates)
- **Billing, Provisional or Contractual Rates** (approved by your customer)
- **Actual Rates** (supported by your accounting system and subject to audit)

Key points to keep in mind...

- Regulations **do not**...
 - Dictate what costs are to be considered direct or indirect (contract might)
 - Dictate how many cost pools you must have
 - More detail generally leads to more accurate allocation of costs
 - Less detail leads to more period to period fluctuations in rates
- Costs are allocated over a fiscal year not a contract performance period
- Keep it simple – easier to understand and audit

Your indirect rate structure must...



Your Organization

**Not be dictated by your accounting software,
your customer or by the Government**

...and the need for a thorough budgeting process.

- Projecting costs associated with:

- Existing business
- New business
- “Transom” business

- Planned changes:

- Personnel
- Operating changes
- Organizational changes

- Economic and political impacts



Standard Rate Structure...

- Rate Calculation

Direct Labor		\$ 100.00
Fringe Benefits	35.00%	\$ 35.00
		<hr/>
		\$ 135.00
Overhead	15.00%	\$ 20.25
		<hr/>
		\$ 155.25
G&A	12.00%	\$ 18.63
		<hr/>
Total Cost		\$ 173.88
Profit or Fee	10.00%	\$ 17.39
		<hr/>
Total Price		<u>\$ 191.27</u>

- Wrap Rate (Cost Only):

= 1.7388

- Wrap Rate (Incl. Profit)

= 1.9127

- Defines the needed price for every dollar of direct labor
- Used in “quick” pricing calculations
- Allows competitive cost comparison

Direct labor costs...

- Represents salary or hourly cost per labor hour for –
 - An average rate per individual
 - Homogeneous grouping of individuals
 - Average rate for individuals performing similar tasks and with similar qualifications
 - Weighted average rate for individuals performing disparate tasks requiring disparate qualifications as a team

Fringe Benefits...

- Expenses incurred for the benefit of the employees
- Apply to both direct and indirect personnel

Fringe costs include but are not limited to:

- Employer federal, state and local payroll taxes (FUTA, SUTA, FICA, etc.)
- Workers compensation
- Holidays, vacations and sick or lost time
- Jury duty, military or bereavement
- Medical, dental and vision
- Short and long-term disability
- Pensions
- Health club dues
- Tuition
- Company contributions to 401(k) or 403(b) plans
- ESOP
- Stock incentive awards (options)
- Parking (at facility)
- Severance
- Life insurance

Fringe benefit rate considerations...

- Customize benefits for categories of employees (retirees, part-time, etc.)
- Benefit packages by division or geographic location
- Bonuses – Yes! No! Maybe!
 - Do they apply equally to all employees
 - Are they a continuing, repetitive costs awarded based on established policy
 - Depending on what impact they have on the rate

Operating/Overhead (O/H) costs...

- Costs associated with assisting direct labor employees in doing their jobs
- Personnel, machinery, supplies, training, etc.

O/H costs include but are not limited to:

- Automobile expenses
- Books and subscriptions
- Professional memberships
- Consulting fees
- Licenses and fees
- Parking and taxi
- Professional meetings/seminars
- Computer supplies
- Computer equipment and maintenance
- Training
- Supporting labor (including applicable fringe benefits)
- Recruiting
- Travel expenses (unless an ODC)
- Depreciation of buildings and equipment
- Utilities
- Facility maintenance
- Overtime premium
- Office supplies
- Communications/telephone
- Postage and shipping

Operating/General Overhead rate considerations...

- May be pooled or accumulated by:
 - Geographic area
 - Product line or service provided
 - Facility (company-site vs. customer-site)
 - Work-at-Home (similar to customer-site)
 - Function (Assembly, Test, Machining, Installation, Design, etc.)
 - Government vs. commercial

Client-site vs. company-site...

- On-site and off-site indirect rate (?)
- Client-site rate should be lower than the company-site rate
- Client-site rate excludes those costs that are not applicable to your employees working at the client-site (i.e. facilities, telephone, internet, computers, etc.)

Selling, General & Administrative (SG&A)...

- Costs associated with the general administration and overall management of the company
- Not assignable to any one final cost objective

SG&A costs include but are not limited to:

- Executive management (CEO, COO, CFO, CIO, President, etc.)
- Finance and accounting
- Business planning
- Sales and marketing
- Information technology
- Human resources and recruiting
- Applicable fringe benefits associated with all indirect labor included)
- Market research
- Dues and subscriptions
- Auto expense
- Board of Directors
- Stockholder/investor relations
- Professional fees (legal counsel, accounting firm, management consultants, etc.)
- Bid and proposal efforts
- Independent research and development efforts
- Travel
- General business insurance
- Payroll processing
- Business licenses and fees

Total cost vs. value-added input allocation base...

- Total cost input base includes all costs incurred except SG&A
 - Predominate rate used – simple and easy
- Value-added input base only includes those costs that you incurred
 - Not purchased materials or services
 - Not major subcontractor efforts
 - Results in a higher rate – may not appear competitive

Material Handling Rate

- Costs incurred in the overall administration of materials acquisition and utilization
- Includes , but not limited to:
 - Purchasing (vendor selection, negotiation and management of purchase orders)
 - Stockroom and stocking
 - Warehouse facility costs
 - Material movement/handling
 - Receiving and inspection/quality control
 - Incoming freight costs
- Segregates material handling costs from the overhead cost pool
- Lowers the overhead rate
- Allocates overhead costs applicable to material only
- Must remain in the allocation base for SG&A

Major Subcontracts Rate

- Subcontracted efforts to support direct contract performance
- Includes, but not limited to:
 - Subcontractor selection and negotiation
 - Contract management
 - Technical evaluation and monitoring
 - Performance management
 - Contract reporting
- Reduces the SG&A allocation base
- Reduces the SG&A expense pool
- Provides a lower adder to subcontract efforts than the full SG&A rate
- SG&A rate will increase on all other efforts

Utilize service centers...

- Requires establishing an allocation method
- Easier way to account for common indirect costs
- Common examples include facilities, IT, telephone, communications, accounting, HR, administration, etc.
- Allocated based on surrogate (e.g., square footage, headcount, usage, etc.)
- All costs allocated out by end of accounting period = zero balance

Establishing a Chart of Accounts

Establish an Organized Chart of Accounts...

- Can be anything that fits your organization
- Make it simple to be able to recognize type of costs included
- As an example:
 - 5000 = Direct Costs
 - 6000 = Fringe Benefit Costs
 - 7000 = Overhead Costs
 - 8000 = General and Administrative Costs
 - 9000 = Unallowable Costs

Consistency in Recording Costs

Required consistency...

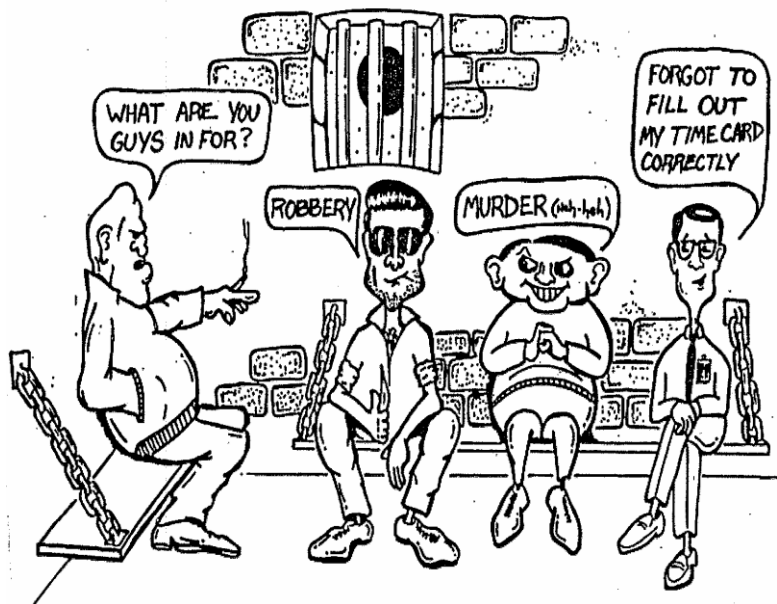
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Developing Proper Labor Recording Practices

What is the significance of proper labor recording?

- Direct labor is generally the most significant contract expenses and basis for indirect cost allocation
- Not supported by third party documentation
- Integral part of an Adequate Cost Accounting System
- Applies to more than cost-type/T&M/labor hour contracts – **applies to all contract types – even commercial.**

Is the Government Really Serious?



- Second largest audit issue behind indirect rates
- Real-Time Labor ~~Evaluations~~ Audits are DCAA's top priority in 2018
- Accuracy impacts product/service costing, pricing and billing
- Deficiencies lead to other audits and potential referrals to investigative agencies

Utilize Total Time Accounting...

- Utilizes an “effective hourly rate” vs. a “standard hourly rate”
- Effective hourly rate can vary from pay period to pay period
 - Salary amount paid remains constant
 - Hours worked can vary as documented by employees time recording
- Does not include any bonus amounts paid
- Not required if salary employee is paid for additional hours (salary paid increases to match additional hours)
- **Preferred by DCAA/Required by FAR 52.237-10**

Labor Cost Per Hour...

Standard Rate Per Hour Calculation

Annual Salary	\$ 118,000.00
Number of Hours:	
Days Per Year	365
Less: Weekend Days	<u>(105)</u>
Adjusted Number of Days	260
Hours Worked Per Day	<u>8</u>
Total Hours Per Year	2,080
Salary Rate Per Hour	<u><u>\$ 56.73</u></u>

Total Time Accounting Rate Calculation*

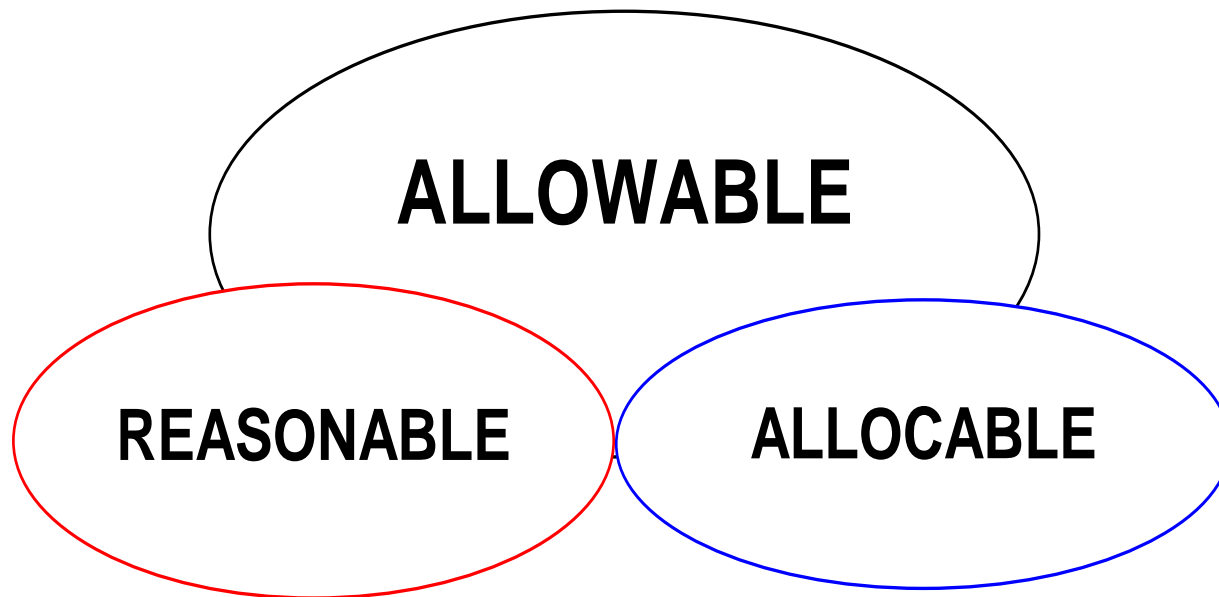
Annual Salary	\$ 118,000.00
Number of Hours:	
Days Per Year	365
Less: Weekend Days	<u>(105)</u>
Adjusted Number of Days	260
Hours Worked Per Day**	<u>12</u>
Total Hours Per Year	3,120
Salary Rate Per Hour	<u><u>\$ 37.82</u></u>

* All hours worked charged.

** Authorized hours only.

Recognizing Unallowable Costs

Reasonable and Allocable = Allowable... (FAR 31-201-2)



Accounting for Unallowable Costs

(FAR Subpart 31.205)

- Defined in FAR Part 31.2, Contract Cost Principles or in the Contract Itself
- Must be excluded from any billing, claim or proposal to the Government



Directly associated costs...

- Any cost generated solely as a result of incurring another cost
- A cost that would have not been incurred had not the other cost been incurred
- When an unallowable cost is incurred its directly associated costs are also unallowable

Selected cost allowability...

- Defined at FAR 31.205
- Fifty (50) costs shown
- Seven (7) are Expressly Unallowable
- Ten (10) identify costs that are Allowable
- Four (4) are generally unallowable with some exceptions
- Twenty-nine (29) are allowable with exceptions

Expressly unallowable costs...

- Defined as a particular item or type of cost which under the express provisions of:
 - applicable law,
 - Regulation (FAR 31.205), or
 - contractual provision,
- is specifically named and stated to be unallowable.
- Includes directly associated “but for” costs

Expressly unallowable costs...

- Bad Debts (FAR 31.205-3)
- Entertainment (FAR 31.205-14)
- Interest and Other Financial Cost (FAR 31.205-20)
- Loss on Other Contracts (FAR 31.205-23)
- Organizational Costs (FAR 31.205-27)
- Goodwill (FAR 31.205-49)
- Cost of Alcoholic Beverages (FAR 31.205-51)

Developing Policies and Procedures

“If you don’t know where you’re going you might not get there”

Yogi Berra, baseball player and manager

Purpose of Policies and Procedures....

- Ensure operating consistency from period to period, contract to contract
- Decrease process variations eliminating waste and increasing efficiencies
- Provide an insurance policy against the impact of personnel loss, turnover and change
- Establish a “road map” to continued compliance

Governments position...

“Effective policies and procedures are the first line of defense against fraud, waste and abuse.”

Defense Contract Audit Agency (DCAA)

- Compliant practices without supporting policies and procedures will result in audit **failure!**

Definitions...

- **Policies**

- Guiding principles of the organization
- Establishes your long-term goals
- Define how you want to live as a citizen

- **Procedures**

- Establish the process for complying your policies
- Defines responsibilities

- **Work Instructions**

- Detailed step by step instructions

Training + Communication = Success



To comply or not comply is not the question!

“If you think compliance is expensive – try non-compliance.”

Former U.S. Deputy Attorney General Paul McNulty



Questions?



Helping Make The Pieces Fit

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