

Government Contract Accounting

John T. Loving, CPA
Loving & Sperry CPAs, LLP
Flower Mound, TX,
www.lovingsperry.com

Why is my accounting system any of the government's business?

- Some government contracts have little or no accounting system requirements.
- How can I tell if a possible contract might have accounting system requirements? Read the solicitation or contract. Usually when the contract price and/or interim payments are based on cost. If price or cash flow is based on cost, the government has an interest in knowing your costs are valid.
 - A. Federal Acquisition Regulation (FAR) Part 15-Contracting by Negotiation
 - The government has issues related to reasonable costs which my family does not have.
 - B. Cost type contracts
 - C. Fixed price type contracts
 - D. Progress payments based on cost

How Does My Basic Accounting Relate to Contract Accounting?

- Balance Sheet (Big Picture-For Understanding Concept Only)

- Accounting Equation:

- A. Assets = Equity

- B. Assets = Liabilities + Capital

- C. Balance Sheet

- Assets:

- Cash
- Accounts Receivable
- Fixed Assets

- Total Assets

\$10,000

- Liabilities

- Accounts and Notes Payable

- Total Liabilities

=====

\$ 4,000

- Capital

- Total Capital

6,000

- Total Liabilities+ Capital

\$10,000

=====

•
•
Generally Not Related to Cost Incurred

How Does My Basic Accounting Relate to Contract Accounting (Continued)?

- Income Statement (Big Picture-For Understanding Concept Only)

| | | |
|--------------------------------------|------------------|------------------|
| • Revenue | | <u>\$100,000</u> |
| • Cost of Sales | | |
| • Possibly Labor | \$ 30,000 | |
| • Material | 20,000 | |
| • Subcontracts | 5,000 | |
| • Rent for Production Line (maybe) | <u>15,000</u> | |
| • Total Cost of Sales | <u>\$ 70,000</u> | <u>\$ 70,000</u> |
| • Gross Profit | | <u>\$ 30,000</u> |
| • General & Administrative expenses- | | |
| • Including labor | <u>\$ 25,000</u> | <u>25,000</u> |
| • Net Profit | | <u>\$ 5,000</u> |
| | | ===== |

Selected Regulations Addressing Accounting Systems

- Federal Acquisition Regulation (FAR) Part 31. Compliance is commonly required.
- Cost Accounting Standards. CAS compliance can become required as companies grow and obtain larger contracts.
- Department of Defense FAR Supplement. Compliance with DFARS requirements are generally for DoD contracts only and are in addition to FAR Part 31. DoD contracts should be reviewed for DFARS clauses.

Standard Form (SF) 1408

- This provides the basic and most common requirements.
- Frequently used by the government as a requirement for a contractor to receive a cost type contract. Should be evaluated by the government in advance of award. Yes-this does mean your company might be evaluated (audited) before you even have a contract.
- Can also apply to subcontracts.
- We will discuss the first eleven requirements of the form

SECTION I - RECOMMENDATION

1. PROSPECTIVE CONTRACTOR'S ACCOUNTING SYSTEM IS ACCEPTABLE FOR AWARD OF PROSPECTIVE CONTRACT

YES

NO (Explain in 2. NARRATIVE)

YES, WITH A RECOMMENDATION THAT A FOLLOW ON ACCOUNTING SYSTEM REVIEW BE PERFORMED AFTER CONTRACT AWARD (Explain in 2. NARRATIVE)

2. NARRATIVE (Clarification of deficiencies and other pertinent comments. If additional space is required, continue on plain sheets of paper.)

SF 1408, Page 1

IF CONTINUATION SHEETS
ATTACHED - MARK HERE

| | | | |
|------------------------------------|---|--|------------------|
| 3. SURVEY MADE BY | a. SIGNATURE AND OFFICE (Include typed or printed name) | b. TELEPHONE NUMBER (include area code) | c. DATE SIGNED |
| 4. SURVEY REVIEWING OFFICIAL | a. SIGNATURE AND OFFICE (Include typed or printed name) | b. TELEPHONE NUMBER (include area code) | c. DATE REVIEWED |

Page 2 of SF 1408

| MARK "X" IN THE APPROPRIATE COLUMN (Explain any deficiencies in SECTION I NARRATIVE) | YES | NO | NOT APPLICABLE |
|---|-----|----|----------------|
| 1. EXCEPT AS STATED IN SECTION I NARRATIVE, IS THE ACCOUNTING SYSTEM IN ACCORD WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES APPLICABLE IN THE CIRCUMSTANCES? | | | |
| 2. ACCOUNTING SYSTEM PROVIDES FOR: | | | |
| a. Proper segregation of direct costs from indirect costs. | | | |
| b. Identification and accumulation of direct costs by contract. | | | |
| c. A logical and consistent method for the allocation of indirect costs to intermediate and final cost objectives. (A contract is final cost objective.) | | | |
| d. Accumulation of costs under general ledger control. | | | |
| e. A timekeeping system that identifies employees' labor by intermediate or final cost objectives. | | | |
| f. A labor distribution system that charges direct and indirect labor to the appropriate cost objectives. | | | |
| g. Interim (at least monthly) determination of costs charged to a contract through routine posting of books of account. | | | |
| h. Exclusion from costs charged to government contracts of amounts which are not allowable in terms of FAR 31, Contract Cost Principles and Procedures, or other contract provisions. | | | |
| i. Identification of costs by contract line item and by units (as if each unit or line item were a separate contract) if required by the proposed contract. | | | |
| j. Segregation of preproduction costs from production costs. | | | |
| 3. ACCOUNTING SYSTEM PROVIDES FINANCIAL INFORMATION: | | | |
| a. Required by contract clauses concerning limitation of cost (FAR 52.232-20 and 21) or limitation on payments (FAR 52.216-16). | | | |
| b. Required to support requests for progress payments. | | | |
| 4. IS THE ACCOUNTING SYSTEM DESIGNED, AND ARE THE RECORDS MAINTAINED IN SUCH A MANNER THAT ADEQUATE, RELIABLE DATA ARE DEVELOPED FOR USE IN PRICING FOLLOW-ON ACQUISITIONS? | | | |
| 5. IS THE ACCOUNTING SYSTEM CURRENTLY IN FULL OPERATION? (If not, describe in Section I Narrative which portions are (1) in operation, (2) set up, but not yet in operation, (3) anticipated, or (4) nonexistent.) | | | |

Relationship to Generally Accepted Accounting Principles-SF 1408 No. 1

| MARK "X" IN THE APPROPRIATE COLUMN (<i>Explain any deficiencies in SECTION I NARRATIVE</i>) | YES | NO | NOT APPLICABLE |
|---|-----|----|----------------|
| 1. EXCEPT AS STATED IN SECTION I NARRATIVE, IS THE ACCOUNTING SYSTEM IN ACCORD WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES APPLICABLE IN THE CIRCUMSTANCES? | | | |

- GAAP requirements are extensive, and include such issues as assets must equal liabilities plus capital.
- “In accordance with GAAP” does not necessarily require 100 percent GAAP compliant statements.
 - Cost vs. benefit
 - GAAP based general purpose financial statements vs. income tax basis vs. FAR based incurred cost submission

Segregate Direct Costs From Indirect-SF 1408 No. 2a

| | | | |
|--|--|--|--|
| 2. ACCOUNTING SYSTEM PROVIDES FOR: | | | |
| a. Proper segregation of direct costs from indirect costs. | | | |

- FAR 31.202 (a) Direct Costs. *“...Direct costs of the contract shall be charged directly to the contract. All costs specifically identified with other final cost objectives ... are direct costs of those cost objectives and are not to be charged to the contract directly or indirectly.”*
 - (b) *For reasons of practicality, the contractor may treat any direct cost of a minor dollar amount as an indirect cost if the accounting treatment---*
 - (1) *Is consistently applied...*
 - (2) *Produces substantially the same results...*

Segregate Direct Costs From Indirect (Continued)

- FAR 31.203 Indirect Costs.
 - *“(b) After direct costs have been determined and charged directly to the contract or other work, indirect costs are those remaining to be allocated....”*
 - *“(c) The contractor shall accumulate indirect costs by logical cost groupings with due consideration of the reasons for incurring such costs. The contractor shall determine each grouping so as to permit use of an allocation base that is common to all cost objectives to which the grouping is to be allocated....”*

Identification and Segregation of Direct Costs by Contract-SF 1408 No. 2b

- *“b. Identification and accumulation of direct costs by contract”*

Commonly called “job costing”. Job costing should include all direct cost categories.

Can include:

Direct Labor

Direct Material

Other Direct Costs, such as travel, reproduction, outside testing, etc.,

Allocation of Indirect Costs, SF 1408 2c

- *c. “A logical and consistent method for the allocation of indirect costs to intermediate and final cost objectives. (A contract is final cost objective.)”-SF 1408 No. 2c*
 - How might a contractor allocate indirect costs to contracts if indirect costs benefit more than one contract?
 - Indirect rates using pools and bases.

One Possible Indirect Cost Allocation Method- Professional Services Company

- Base:

- Direct Labor \$1,000,000

- Pool:

- Indirect Labor \$ 500,000
 - Rent, Utilities, training, etc. 800,000
 - Total Pool \$ 1,300,000

- Rate

130%

One Possible Indirect Cost Allocation Method

Machine Shop with In-House and Field Personnel

| <u>Base</u> | <u>Mach. Labor</u> | <u>Field Svc. Labor</u> | <u>G&A</u> |
|---------------|--------------------|-------------------------|--------------------|
| | • <u>\$500,000</u> | <u>\$300,000</u> | <u>\$1,500,000</u> |
| • Pool: | | | |
| • Fringes | \$150,000 | \$ 90,000 | \$ 15,000 |
| • Rent, util. | 300,000 | 0 | 20,000 |
| • Ind. Labor | | | |
| with Super. | <u>100,000</u> | <u>60,000</u> | <u>50,000</u> |
| Total | <u>\$ 550,000</u> | <u>\$ 150,000</u> | <u>\$ 85,000</u> |
| Rate | <u>110%</u> | <u>50%</u> | <u>5.67%</u> |

Accumulation of Costs Under General Ledger Control, SF 1408 2d

- d. Accumulation of costs under general ledger control
 - An income statement account for each direct cost element, such as labor.
 - Shows the company-wide costs for each direct cost element for the period.
 - Ties to the sum of the direct cost element for all contracts.
 - Total direct cost of a contract is the sum of each annual direct cost amount.
 - Total indirect cost is the sum of indirect costs applied each year.

A timekeeping system that identifies employees' labor by intermediate or final cost objectives, SF 1408 2e

- *“e. A timekeeping system that identifies employees' labor by intermediate or final cost objectives”*
 - Involves coordination of payroll with labor portion of job cost.
 - Can be accomplished with in-house payroll processing or outside.
 - Can be an area considered a risk by the DCAA and subject to in-depth audit.
 - The DCAA has internal control preferences. Worthy of consideration.

Labor Distribution System, SF 1408 2f

- *“f. A labor distribution system that charges direct and indirect labor to the appropriate cost objectives.”*
- A continuation of 2e. Tracked in 2e then charged correctly in 2f.

Interim Posting of Costs, SF 1408 g

- *“g. Interim (at least monthly) determination of costs charged to a contract through routine posting of books of account.”*
 - Most common accounting software provides for at least monthly financial posting and statements.
 - Some companies use separate job costing software, which might be integrated into the GL or might require manual posting at least monthly.
 - If Excel or similar is used for job costing, manual entries should be posted to the general ledger at least once per month. Use of spreadsheets is unusual at this time.

Unallowable Costs, SF 1408h

- *“h. Exclusion from costs charged to government contracts of amounts which are not allowable in terms of FAR 31, Contract Cost Principles and Procedures, or other contract provisions.”*
 - FAR 31.205 addresses expressly unallowable costs.
 - Some commonly incurred costs are expressly unallowable.
 - If FAR Part 31.205 applies, some costs incurred will likely not be reimbursed.
 - If costs are not reimbursed, profit is reduced.

Identification of Costs by Contract Line Items and/or by Unit, SF 1408i

- *“i. Identification of costs by contract line item and by units (as if each unit or line item were a separate contract) if required by the proposed contract.”*
 - Some contracts have different ways of paying various contract line items (CLINS), For example, fixed price vs. cost type.
 - The government might use cost by unit to establish cost trends to help price future contracts.

Segregation of Preproduction Costs From Production Costs, SF 1408j

- *“j. Segregation of preproduction costs from production costs.”*
 - What are *“preproduction costs”*?
 - Timing?
 - Get ready?
 - Rearrangement?
 - Non-recurring?
 - Pricing future work.

What Software Can Allow Compliance?

- Most accounting software **can** allow compliance.
- Questions are:
 - Cost vs. benefit? More capable software is usually more complex and harder to implement/learn.
 - How many manual steps must your employees employ?
 - The more steps the greater chance of errors.
 - The more steps the larger your employee cost.
 - Unwarranted vs. warranted fear.
 - What information other than pure accounting related does management want or need?
 - Project management?
 - Inventory management?
 - Budget vs. actual?
 - Less manually complex billing procedures?

Questions