

# Accounting Systems: Complying with FAR Requirements



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# Background Information

- FAR Requirements
  - FAR Part 9: Contractor Qualifications
  - FAR Part 16: Cost-reimbursement Contracts
  - DFARS Part 232: Financial Responsibility

# FAR Requirements

- Requires organizations have:
  - Financial resources to perform
  - Integrity and business ethics
  - Technical ability to perform
  - Accounting system to accumulate the costs on the contract

# Preaward Surveys

- Accounting System
  - Review of various accounting data to determine if system is adequate for accumulating and reporting costs on a contract (SF 1408)
- Financial Capability
  - Review of key financial data, balance sheet, income statement, and cash flows to ensure that the contractor has the financial resources to complete the contract (SF 1407) (FAR 16.301-1)

# Accounting System

- Review to determine the acceptability of the system for accumulating costs under a Government contract
- Review the design and operation of the system to reach an informed opinion on whether the system is acceptable for Government contracts

# Accounting System

- Contractor's Control Environment
  - Sets the tone of an organization
  - Foundation for all other components of internal control – providing discipline and structure
- Contractor's Overall Accounting Controls
  - Financial controls concerned with ensuring reliable financial data and statements
  - Compliance controls concerned with ensuring compliance with applicable laws and regulations

# Control Environment

## ● Integrity and Ethical Values

- Written code of conduct addressing ethical business practices, conflicts of interest, and standards of ethical behavior
- System of identifying noncompliances with codes of conduct and corrective actions
- Self-governance programs

# Control Environment

- Board of Directors/Audit Committee
  - Independent and actively involved in significant decisions
  - Audit committee is effective in reviewing internal and external audit recommendations

# Control Environment

- Organization Structure and Assignment of Authority and Responsibility
  - Assignment of responsibility and delegation should provide a basis of accountability and control
  - Ensure a segregation of duties critical to the internal controls

# Accounting System

- Consist of methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions
- Maintain accountability for related assets and liabilities
- Well designed to provide reliable accounting data and prevent misstatements that would otherwise occur

# Accounting System

- Accounting system is adequate if:
  - Procedures are adequate to protect the Government's interest
  - Compliance with CAS

# Accounting System

- GAAP
- Proper segregation of costs
- Direct costs by contract
- Allocation of indirect costs
- Costs under general ledger control
- Timekeeping system
- Labor distribution
- Exclusion of unallowable costs
- Interim determination of costs
- Costs by contract line item
- Limitation of costs
- Billings
- Adequate & reliable

# GAAP

- Accumulation of all accounting data is based on generally accepted accounting principles
- Supportable by internal and external auditing processes

# Proper Segregation of Costs

- Establishment of a Chart of Accounts defining direct and indirect functions
- Controls in place to preclude direct charging of indirect expenses
- Controls in place to preclude indirect charging of direct contract costs

# Direct Costs by Contract

- Establishment of a Chart of Accounts defining various contracts
- A subsidiary job cost ledger which accumulates costs by contract and is reconciled to the general ledger
- Controls in place to preclude mischarging of one contract effort with another contract

# Allocation of Indirect Costs

- Policies and procedures in place for the accumulating and billing of indirect expenses
- Accumulation in logical groupings and allocated based on benefits accrued to intermediate and final cost objectives
- Cost accounting system is formally documented with a written description of the contents of the bases and pools

# Costs Under General Ledger Control

- Contractor's job cost ledger, labor distribution, and other books of account are reconcilable to the general ledger
- Posting to the books of account and the reconciliations are done on a current basis

# Guidelines on Timekeeping

- Significant issue since it involves the largest component of cost on contracts
- A matter of internal controls

# CMS Emphasis

- Focus is on a system of internal controls
- What has the contractor established in both procedures and compliance to reduce the overall risk in the area of labor costs

# Guidelines on Timekeeping

- Policies and procedures governing the accumulation and billing of labor costs
  - Procedures for timekeeping
  - Procedures for processing payroll
  - Procedures for labor corrections and transfers

# Internal Controls Over Labor

- Effective method to monitor overall integrity of the labor/timekeeping system
  - Conduct regular internal reviews that address: policies, consistent application of them, and follow-up on any deficiencies noted
  - Perform floorchecks, review of exception reports, etc.

# Timekeeping

- Effective employee awareness training program
  - Policies and procedures to ensure that all employees are aware of the importance of proper time charges
  - New hires training and refresher courses for existing employees
  - Awareness of penalties imposed by the government (i.e. False Claims Act)
  - Goes to the issue of top management creating an ethical environment

# Timekeeping

- Effective labor authorization/approvals
  - Procedures to facilitate the accumulation and recording of labor costs to the proper cost objectives
  - Segregation of duties between key personnel (i.e. Timekeeping vs. Payroll)
  - Supervisors who are accountable for meeting budgets should not have the opportunity to initiate changes to employees time charges

# Timekeeping

- Effective description of work
  - Procedures to facilitate the clear identification of the nature of the work performed
  - Enough detail to be trackable to the final cost objective
  - Sufficient to determine the allocability of the charges to government contracts/grants

# Timekeeping

- Effective timekeeping system
  - Procedures to assure that the labor hours are accurately recorded
  - Any changes are properly documented including authorizations

# Timekeeping

- Manual timekeeping system
  - Timesheets are preprinted with employee name and ID number
  - Employees prepare their timesheets in ink, on a daily basis
  - Supervisory observations of employee arrivals and departures

# Timekeeping

- Manual timekeeping system
  - Corrections are made in ink, initialed by employee, properly authorized and explanation for revision
  - Employee and supervisor sign timesheet verifying the accuracy of the recorded labor

# Timekeeping

- Electronic timekeeping system
  - Employee badge issuance is controlled (no duplication, no unauthorized persons)
  - Procedures in place requiring reporting of lost badges
  - Revisions are documented via electronic passwords
  - Same audit trail as in the manual system even though it is electronic

# Labor Distribution

- Effective labor distribution
  - Policies to require verification of the hours in the labor distribution summary agrees with the hours entered into the timekeeping and payroll systems
  - Procedures that generate an audit trail documenting the distribution of direct and indirect labor charges to the proper cost objectives

# Labor Distribution

- Other effective controls
  - Review significant increases and decreases in sensitive labor accounts
  - Procedures that ensure proper documentation of labor transfers or adjustments
  - Procedures addressing overtime authorization

# Interim Pricing

- Contractor posts contract costs at least monthly to books of account
- Contractor utilizes provisional indirect rates and monitor the rates for any significant variance
- Contractor compares the actual expenditures to the contract amounts

# Exclusion of Unallowables

- Procedures in place to identify and exclude unallowable costs from any government billing in accordance with FAR 31
- Chart of accounts in place that supports the policies
- Employees trained in the area of what constitutes an unallowable cost

# Costs by Contract Line Item

- Contractor has procedures in place to determine the appropriate level of reporting cost information that corresponds to Government requirements
- Can the contractor's system be expanded to the requisite level of detail

# Limitation of Costs

- Total contract expenditures against contract limitations on price or cost are monitored and updated
- Controls exists to ensure compliance with reporting requirements of FAR 52.216-5,-6,-7,-16 and -17 or FAR 52.232-20, -21, -22

# Billing/Reimbursements

- Claimed costs can be traced to the job cost ledger
- Provisional rates utilized to bill the indirect expenses
- Standard Form 1034 properly completed

# Contract Briefs

- Synopsis of all pertinent provisions
- Type, amount, service provided
- Types of indirect rates
- Any ceilings or billing limitations

# Adequate, Reliable Data

- Is the accounting system kept on a current basis; and
- Is cost information capable of producing information at sufficient level of detail for use in pricing follow-on contracts

# Financial Capability

- Assessment to determine if contractor is financially capable of performing on Government contracts
- Financial difficulties may
  - Disrupt schedules
  - Result in contract nonperformance

# Financial Capability

- Early assessment of contractor difficulty allows flexibility to the Government to:
  - Avoid loss of critical services
  - Protect Government property and inventory
  - Develop alternative sources
  - Assessment to determine if contractor is financially capable of performing on Government contracts

# Financial Capability

- Early assessment of contractor difficulty allows flexibility to the contractor:
  - Borrowing of money
  - Liquidating of assets
  - Reducing capital expenditures
  - Reducing workforce

# Financial Capability

- Evaluating various financial data including:
  - Three to five years of audited financial statements
  - Analytical review utilizing key financial ratios
  - Evaluation of cash flow projections
  - Review of off-balance sheet items
  - Review of related party transactions

# Key Financial Ratios

| Ratio                      | Formula   |
|----------------------------|---|
| Current Ratio              | Current Assets/Current Liabilities  |
| Acid Test (Quick Ratio)    | Liquid Assets/Current Liabilities   |
| Return on Investment (ROI) | Net Income/Total Assets   |
| Debt to Equity Ratio       | Total Debt/ Stockholders Equity   |
| Cash Flow to Debt          | Cash Flow (Net Income+ Depreciation + Depletion + Amortization)/Total Debt        |
| Cash Flow Return on Assets | Cash from Operations/Total Assets   |
| Cash Flow to Sales         | Cash from Operations/Sales  |
| Cash Flow Adequacy         | Cash from Operations/(Long-term Debt Paid + Purchases of Assets + Dividends Paid) |
| Debt Coverage              | Total Debt/Cash from Operations   |

# Financial Capability

- Assessment will conclude with:
  - Satisfactory comments relative to data
  - Conditions of quarterly monitoring of future interim financial statements
  - Denial of contract award

# Questions and Answers