

FORVIS



CAS: The Series – *Episode 6: Home Office Allocations – CAS 403*

A 12-part webinar series on the Cost Accounting Standards

Your Instructors



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Agenda

- Layout of the series
- CAS 403 – Home Office Allocations

Polling Question

Where are you working from today?

1. Home or alternate work location
2. My company office
3. A different work location
4. Traveling
5. Other



Layout of the Series

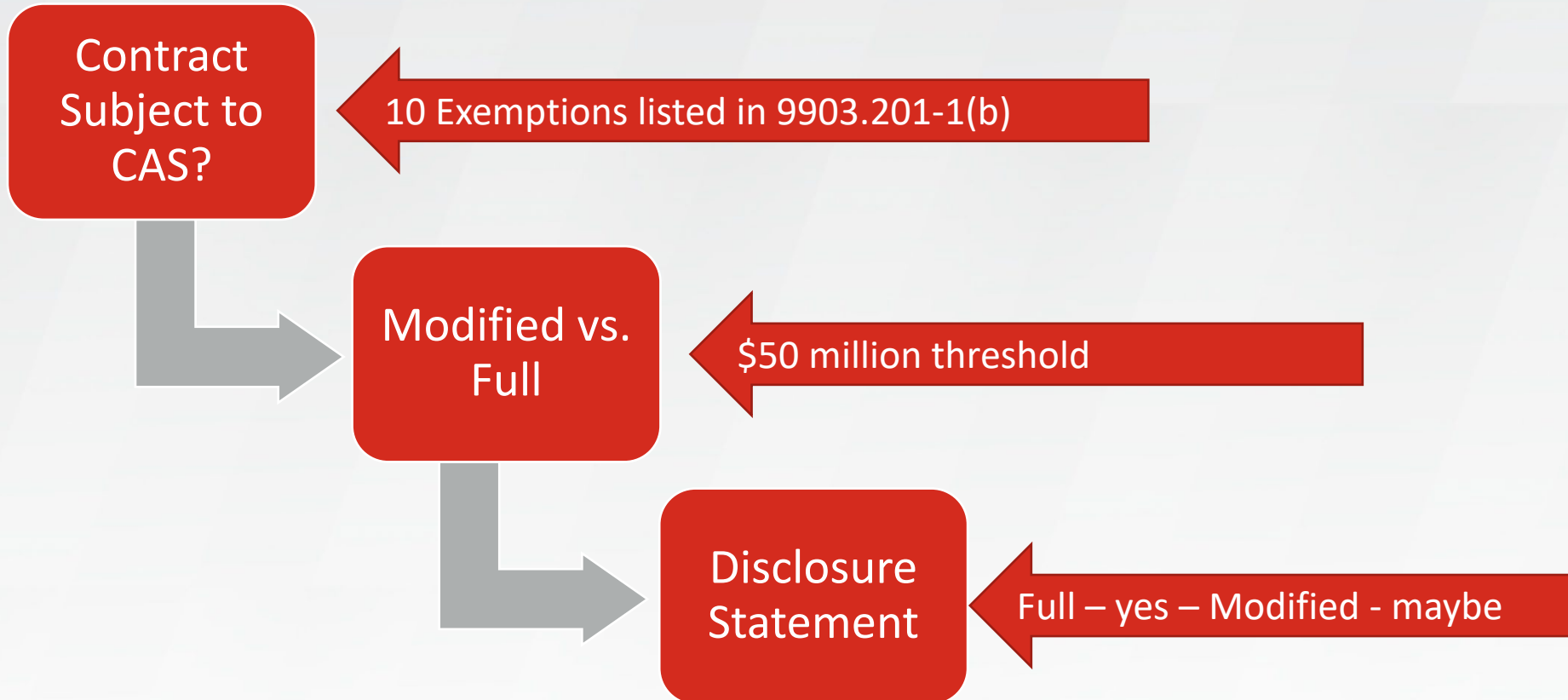
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CAS in a minute!

- Contracts are subject to CAS – not contractors!



Layout of CAS the Series

- Pilot Episode – 90-minute webinar to kick off the series
- Individual 90-minute episodes:
 - Episode 1 – CAS Clauses, Exemptions and Full/Modified CAS
 - Episode 2 – Cost Accounting Practice Changes & Administration
 - Episode 3 – CAS 401, 402, 405 & 406
 - Episode 4 – Compensation – CAS 408, 412, 413 & 415
 - Episode 5 – Direct and Indirect Costs – CAS 418
 - **Episode 6 – Home office allocations – CAS 403**

Layout of CAS the Series

- Episode 7 – G&A and B&P/IR&D – CAS 410 & 420
- Episode 8 – COM and Standard Costs – CAS 407, 414 & 417
- Episode 9 – Assets & Material – CAS 404, 409 & 411
- Episode 10 – Insurance and CAS 419 – CAS 416 and the mystery of CAS 419
- Episode 11 – Disclosure Statements
- Episode 12 – CAS Administration – Roles of DCMA & DCAA

The Cost Accounting Standards

■ BASIC Standards

- CAS 401: Consistency
- CAS 402: Direct v. Indirect Costs
- CAS 405: Unallowable Costs
- CAS 406: Cost Accounting Period

■ The Cost Allocation Standards

- CAS 407: Standard Costs
- CAS 414: Cost of Money
- CAS 410: General & Administrative
- **CAS 403: Home Office expenses**
- CAS 418: Direct & Indirect
- CAS 420: B&P and IR&D

■ Asset Accounting Standards

- CAS 404: Capitalization
- CAS 409: Depreciation
- CAS 417: Self Constructed Assets

■ Compensation Standards

- CAS 408: Compensated Assets
- CAS 412 & 413: Pensions
- CAS 415: Deferred Compensation

■ Other Standards

- CAS 411: Material Costs
- CAS 416: Insurance Costs

The Format of the Standards

- Purpose (.20)
- Definitions (.30)
- Fundamental Requirement (.40)
- Techniques for Application (.50)
- Illustrations (.60)
- Interpretation (.61)
- Exemption (.62)
- Effective Date (.63)

CAS 403

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INSTITUTE**

History

- Published on December 14, 1972
- Took effect on April 17, 1992
- The 3rd Standard promulgated by the CAS Board
- The 1st Standard that addressed a specific type of cost
- Industry was concerned with inequities resulting from residual allocation requirements
- Government was concerned that flexibilities available under the ASPR were being limited by the new Standard

CAS 403 – Home Office Allocations

- Establishes criteria for allocation of the expenses of a home office to the segments of the organization based on the beneficial or causal relationship between such expenses and the receiving segments
- Provides for:
 - Identification of expenses for direct allocation to segments to the maximum extent practical;
 - Accumulation of significant nondirectly allocated expenses into logical and relatively homogeneous pools to be allocated on bases reflecting the relationship of the expenses to the segments concerned; and
 - Allocation of any remaining or residual home office expenses to all segments.
- Goal is to minimize the amount of home office expenses classified as residual to the expenses of managing the organization as a whole.
- Does not cover the reallocation of a segment's share of home office expenses to contracts and other cost objectives (That is CAS 410 next week!)

CAS 403 - Definitions

- **Allocate** means to assign an item of cost, or a group of items of cost, to one or more cost objectives. This term includes both direct assignment of cost and the reassignment of a share from an indirect cost pool.
- **Home office** means an office responsible for directing or managing two or more, but not necessarily all, segments of an organization.
 - Typically establishes policy for and provides guidance to the segments in their operations.
 - Usually performs management, supervisory, or administrative functions of the various segments
- **Operating revenue** means amounts accrued or charged to customers, clients, and tenants for the sale of products manufactured or purchase for resale, for services, and for rentals of property held primarily for leasing to others. It includes both reimbursable costs and fees under cost-type contracts and percentage-of-completion sales accruals except that it includes only the fee for management contracts under which the contractor acts essentially as an agent of the Government in the erection of operation of Government-owned facilities.
 - Excludes incidental interest, dividends, royalty, and rental income, and proceeds from the sale of assets used in the business.
- **Segment** means one or two or more divisions, product departments, plants, or other subdivisions of an organization reporting directly to a home office, usually identified with responsibility for profit and/ or producing a product or service.
 - Includes Government-owned contractor-operated (GOCO) facilities, and joint ventures and subsidiaries (domestic and foreign) in which the organization has a majority ownership.
 - Includes those joint ventures and subsidiaries (domestic and foreign) in which the organization has less than a majority of ownership, but over which it exercises control.
- **Tangible Capital Asset** means an asset that has physical substance, more than minimal value, and is expected to be held by an enterprise for continued use or possession beyond the current accounting period for the services it yields

CAS 403 – Fundamental Requirement

- Home office expenses must be allocated based on the basis of the beneficial or causal relationship between supporting and receiving activities
- Expenses shall be allocated directly to segments to the maximum extent practical.
- Expenses not directly allocated, if significant in amount and in relation to total home office expenses, shall be grouped in logical and homogeneous expense pools and allocated based on the guidance in the Standard
- Using these allocations shall minimize - to the extent practical - the amount of expenses left as residual – in essence - those of managing the organization as a whole
- Residual expenses shall be allocated based pursuant to paragraph (c) of this subsection.
- Consistent with CAS 402 – the Standard requires that no segment shall have allocated to it as an indirect cost, either through a homogeneous expense pool, or the residual expense pool, any cost, if other costs incurred for the same purpose have been allocated directly to that or any other segment.

Fundamental Requirement – Certain Groups

- Centralized service functions. Expenses of centralized service functions performed by a home office for its segments shall be allocated to segments on the basis of the service furnished to or received by each segment.
- Staff management of certain specific activities of segments. The expenses incurred by a home office for staff management or policy guidance functions which are significant in amount and in relation to total home office expenses shall be allocated to segments receiving more than a minimal benefit over a base, or bases, representative of the total specific activity being managed.
- Line management of particular segments or groups of segments. The expense of line management shall be allocated only to the particular segment or group of segments which are being managed or supervised. If more than one segment is managed or supervised, the expense shall be allocated using a base or bases representative of the total activity of such segments.

Fundamental Requirement – More Groups

- **Central payments or accruals:**
 - made by a home office on behalf of its segments shall be allocated directly to segments to the extent that all such payments or accruals of a given type or class can be identified specifically with individual segments.
 - that cannot be identified specifically with individual segments shall be allocated to benefitted segments using an allocation base representative of the factors on which the total payment is based.
- **Independent research and development costs and bid and proposal costs** of a home office shall be allocated in accordance with CAS 420
- **Staff management not identifiable with any certain specific activities of segments.** The expenses incurred by a home office for staff management, supervisory, or policy functions, which are not identifiable to specific activities of segments shall be allocated as residual expenses.

Fundamental Requirement – Residual Expenses

- All home office expenses which are not allocate directly or through a homogeneous allocation, shall be deemed residual expenses. Typical residual expenses are those for the chief executive, the chief financial officer, and any staff which are not identifiable with specific activities of segments.
- Residual expenses shall be allocated to all segments under a home office by means of a base representative of the total activity of the segments
- Residual expenses shall be allocated using the 3-factor formula is amount of residual expenses for the previous fiscal year (excluding unallowable costs and special allocations) exceeds the amount obtained by applying the following percentage(s) to the aggregate operating revenue of all segments for the previous year:
 - 3.35 percent of the first \$100 million;
 - 0.95 percent of the next \$200 million;
 - 0.30 percent of the next \$2.7 billion;
 - 0.20 percent of all amounts over \$3 billion.
- A special allocation can be used where a particular segment receives significantly more or less benefit from residual expenses than would be reflected by the allocation under the methods described above.
 - The Government and the contractor may agree to a special allocation of residual expenses to such segment commensurate with the benefits received.
 - The amount of a special allocation to any segment made pursuant to such an agreement shall be excluded from the pool of residual expenses and segment's data shall be excluded from the base

CAS 403 – Techniques for Application - Grouping

- Separate expense groupings will ordinarily be required
 - The number of groupings will depend primarily on the variety and significance of service and management functions performed by a particular home office
 - Ordinarily, each service or management function will have to be separately identified for allocation by means of an appropriate allocation technique
 - It is not necessary to identify and allocate different functions separately, if allocation can be made using a common allocation base.
- Where the expense of a given function is to be allocated by means of a particular allocation base, all segments shall be included in the base unless:
 - Any excluded segment did not receive significant benefits from, or contribute significantly to the cause of the expense to be allocated and,
 - Any included segment did receive significant benefits from or contribute significantly to the cause of the expense in question.

Techniques for Application – Allocation Bases

- The allocation of centralized service functions shall be governed by a hierarchy of preferable allocation techniques which represent beneficial or causal relationships.
 - The preferred representation is a measure of the activity of the organization performing the function.
 - + Supporting functions are usually labor-oriented, machine-oriented, or space-oriented.
 - + Measures of the activities ordinarily can be expressed in terms of labor hours, machine hours, or square footage.
 - + Costs shall be allocated by use of a rate, such as a rate per labor hour, rate per machine hour or cost per square foot, unless such measures are unavailable or impractical to ascertain. In these latter cases the basis for allocation shall be a measurement of the output of the supporting function.
- Output is measured in terms of units of end product produced by the supporting function, as for example, number of printed pages for a print shop, number of purchase orders processed by a purchasing department, number of hires by an employment office.
- Where neither activity nor output of the supporting function can be practically measured, a surrogate for the beneficial, or causal relationship must be selected. Any surrogate used should be a reasonable measure of the services received and, logically, should vary in proportion to the services received.

Techniques for Application – The 3 Factor Formula

- Where required, the three-factor formula described below must be used to allocate residual expenses.
- The CASB determined that this formula results in appropriate allocations of the residual expenses of home offices. It takes into account three broad areas of management concern:
 - The employees of the organization,
 - the business volume, and
 - the capital invested in the organization.
- The three-factor formula is the arithmetical average of the following three percentages for the same period:
 - The percentage of the segment's payroll dollars to the total payroll dollars of all segments.
 - The percentage of the segment's operating revenue to the total operating revenue of all segments.
[For this purpose, the operating revenue of any segment shall include amounts charged to other segments and shall be reduced by amounts charged by other segments for purchases.]
 - The percentage of the average net book value of the sum of the segment's tangible capital assets plus inventories to the total average net book value of such assets of all segments. *[Property held primarily for leasing to others shall be excluded from the computation. The average net book value shall be the average of the net book value at the beginning of the organization's fiscal year and the net book value at the end of the year.]*

CAS 403 – The 3 Factor Formula Example

	Payroll Dollars		Operating Revenue		Average NBV		3 Factor Formula
	<u>Dollars</u>	<u>%</u>	<u>Dollars</u>	<u>%</u>	<u>Dollars</u>	<u>%</u>	
Segment 1	\$ 45,000	25%	\$ 1,200,000	20%	\$ 4,500	13%	19.6%
Segment 2	32,000	18%	750,000	13%	3,500	10%	13.6%
Segment 3	5,000	3%	1,500,000	25%	25,000	72%	33.6%
Segment 4	95,000	54%	2,450,000	42%	1,500	4%	33.2%
	<u>\$ 177,000</u>		<u>\$ 5,900,000</u>		<u>\$ 34,500</u>		

CAS 403 – Special Allocations

- An indication that a segment received significantly less benefit in relation to other segments can arise if a segment, unlike all or most other segments, performs on its own many of the functions included in the residual expense.
- Another indication may be that, in relation to its size, comparatively little or no costs are allocable to a segment
- Evidence of comparatively little communication or interpersonal relations between a home office and a segment, in relation to its size, may also indicate that the segment receives significantly less benefit from residual expenses. Conversely, if the opposite conditions prevail at any segment, a greater allocation may be indicated. This may be the case, for example, if a segment relies heavily on the home office for certain residual functions normally performed by other segments on their own.
- Segments which may require special allocations of residual expenses include, but are not limited to foreign subsidiaries, GOCO's, domestic subsidiaries with less than a majority ownership, and joint ventures.
- The portion of residual expenses to be allocated to a segment pursuant shall be the cost of estimated or recorded efforts devoted to the segments.

CAS 403 – Different Legal Entities

- Home office functions may be performed by an organization which for some purposes may not be a part of the legal entity with which the Government has contracted.
- This situation may arise, for example, in instances where the Government contracts directly with a corporation which is wholly or partly owned by another corporation. In this case, the latter corporation serves as a “home office,” and the corporation with which the contract is made is a “segment” as those terms are defined and used in this Standard.
- For purposes of contracts subject to CAS 403, the contracting corporation may only accept allocations from the other corporation to the extent that such allocations meet the requirements in CAS 403 for allocation of home office expenses to segments.

CAS 403 – Illustration #1

Home office expense or function	Illustrative allocation bases
Centralized service functions:	
1. Personnel administration	1. Number of personnel, labor hours, payroll, number of hires.
2. Data processing services	2. Machine time, number of reports.
3. Centralized purchasing and subcontracting	3. Number of purchase orders, value of purchases, number of items.
4. Centralized warehousing	4. Square footage, value of material, volume.
5. Company aircraft service	5. Actual or standard rate per hour, mile, passenger mile, or similar unit.
6. Central telephone service	6. Usage costs, number of instruments.

CAS 403 – Illustration #2

Home office expenses or function	Illustrative allocation bases
Staff management or specific activities:	
1. Personnel Management	1. Number of personnel, labor hours, payroll, number of hires
2. Manufacturing policies, (QC, industrial engineering, production, scheduling, tooling, inspection & testing, etc.	2. Manufacturing cost input, manufacturing direct labor
3. Engineering policies	3. Total engineering costs, engineering direct labor, number of drawings
4. Material/ purchasing policies	4. Number of purchase orders, value of purchases
5. Marketing policies	5. Sales, segment marketing costs

CAS 403 – Illustration #3

Home office expenses or function	Illustrative allocation bases
Central payments or accruals:	
1. Pension Expenses	1. Payroll or other factor on which total payment is based
2. Group Insurance Expenses	2. Payroll or other factor on which total payment is based
3. State and local income taxes & franchise taxes	3. Any base or method which results in an allocation that equals or approximates a segment's proportionate share of the tax imposed by the jurisdiction in which the segment does business, as measured by the same factors used to determine taxable income for that jurisdiction.

CAS 403 – Interpretation

- A major issue was almost immediately litigated allocation of state income taxes
- A CAS 403 illustration state that income taxes are to be allocated by “any base or method which results in an allocation that equals or approximates a segment's proportionate share of the tax imposed by the jurisdiction in which the segment does business, as measured by the same factors used to determine taxable income for that jurisdiction.”:
- The taxes of any particular jurisdiction are to be allocated only to those segments that do business in the taxing jurisdiction, and
- Where there is more than one segment in a taxing jurisdiction, the taxes are to be allocated among those segments on the basis of “the same factors used to determine the taxable income for that jurisdiction.”
- Segment book income is to be used as a factor in allocating income tax expense from a home office to segments only where this amount is expressly used by the taxing jurisdiction in computing the income tax.

Fun Facts about CAS 403

- 3 Factor Formula based on state tax apportionment formulas
- Numerous cases on tax allocations – too many to discuss
- Other home office expenses:
 - *General Dynamics Corp* – data processing costs allocated using average rates rather than actual cost to segments
 - *Martin Marietta Corp.* – allocating aircraft product liability insurance only to segments producing aircraft or space products
 - *Teledyne Continental Motors* – Pension cost prior to CAS 412 / CAS 413

Positioning for future sessions . . .

October 12th – 2:00 Eastern . . .

Episode 7 – G&A and B&P/ IR&D – CAS 410 and 420

Government Contracting

Last Chance for Some Questions

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