

FORVIS



CAS: The Series – *Episode 5:* *CAS 418 Direct and Indirect Costs*

A 12-part webinar series on the Cost Accounting Standards

Your Instructors



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Agenda

- Layout of the series
- CAS 418 – Allocation of Direct and Indirect Costs

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

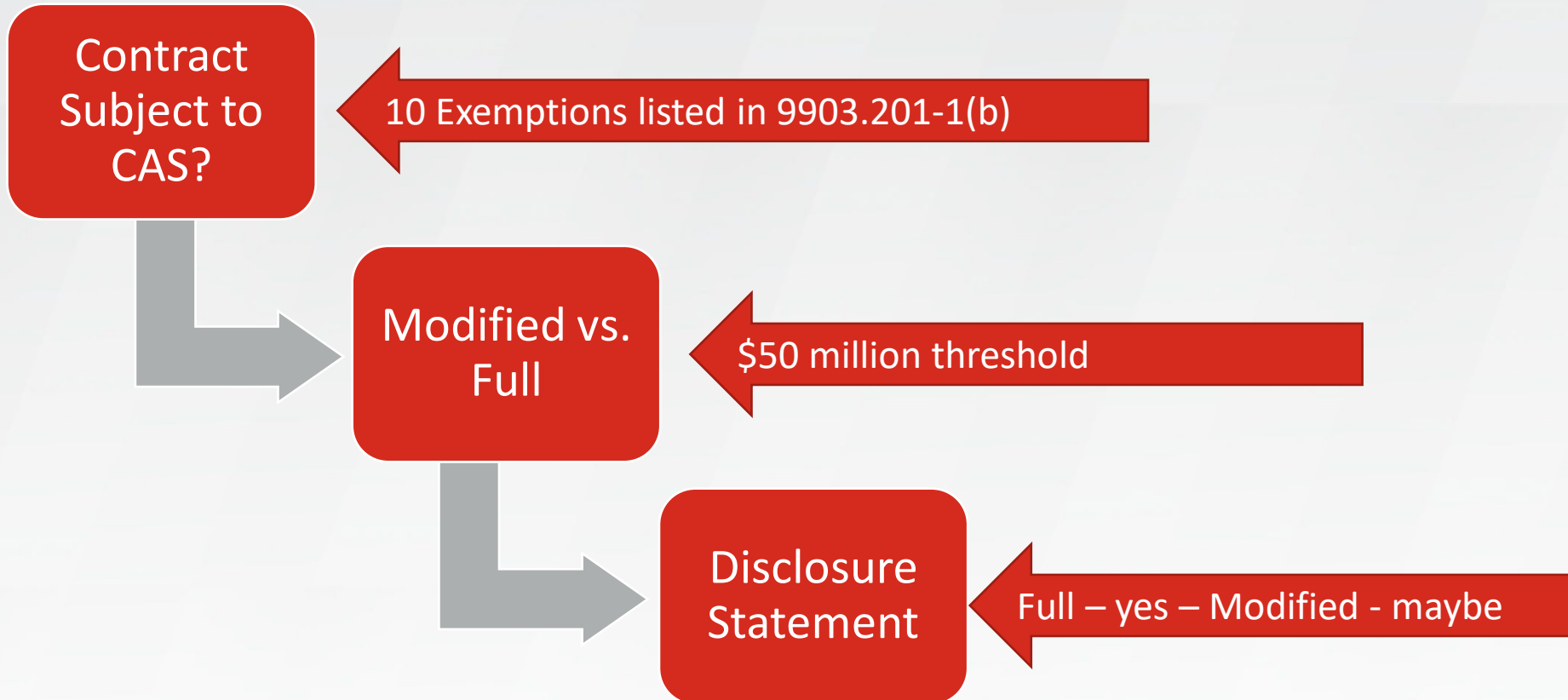
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CAS in a minute!

- 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 418

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History

- Published on May 15, 1980
- Took effect on September 20, 1980 (remember the CAS Board went out of business on September 30, 1980)
- Effective at the beginning of the contractor's second full fiscal year after award of a contract subject to full CAS
- CASB initially proposed 5 separate Standards to distinguish between direct and indirect costs and for the allocation of indirect costs.
- Massive pushback from industry – felt the proposed Standards were too prescriptive (Hint – part of the CAS 419 saga in Episode 10)
- Proposed CAS 420 (not the IR&D/B&P that we know) included a provision regarding uncompensated overtime (UCOT) requiring contractors to record all hours worked – the CASB specifically considered and rejected this provision.

CAS 418 – Allocation of Direct & Indirect Costs

- Determination of direct & indirect costs
- Accumulation of indirect costs, including service center and overhead costs, in indirect cost pools
- Selection of allocation measures based on the beneficial or causal relationship between an indirect cost pool and cost objectives
- Higher level purpose: To improve classification of costs as direct & indirect and the allocation of indirect costs

Polling Question #2

A company with contracts subject to CAS coverage does not have a written policy and procedure for allocating costs as direct or indirect. Is this company in compliance with CAS 418?

- Yes
- No
- Need more information



CAS 418 - 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. *(CAS 402 & CAS 406)*
- **Direct cost** means any cost which is identified specifically with a particular final cost objective. Direct costs are not limited to items which are incorporated in the end product as material or labor. Costs identified specifically with a contract are direct costs of that contract. All costs identified specifically with other final cost objectives of the contractor are direct costs of those cost objectives. *(CAS 402)*
- **Indirect cost** means any cost not directly identified with a single final cost objective but identified with two or more final cost objectives or with at least one intermediate cost objective. *(CAS 402, 405, 406)*
- **Indirect cost pool** means a grouping of incurred costs identified with two or more cost objectives but not identified specifically with any final cost objective. *(CAS 401, 402, 405, 406)*

CAS 418 – Fundamental Requirement

- Must have a written “statement of policies and practices for classifying costs as direct or indirect” consistently applied
- Indirect costs must be accumulated in homogenous cost pools allocated “in reasonable proportion to the beneficial or causal relationship”
- Pooled costs:
 - Management or supervision of activities involving direct labor or direct material:
 - Resource consumption cannot be specifically identified to a cost objective
 - Must use a base representative of the activity managed/supervised.
- Otherwise, use one of the following:
 - A resource consumption measure,
 - An output measure, or
 - A surrogate that is representative of resources consumed.
- Comprehensive requirements for selecting allocation base
- Cost allocations required by other CAS are not subject to the provisions of CAS 418
- Does not cover costs of special facilities accounted for in separate indirect cost pool

CAS 418 – Determination of Direct & Indirect Cost

- Focus is on “Business unit” cost accounting practices
- Written policy must be in compliance with CAS 418
- Must use actual costs, except that -
 - Standard costs for material and labor may be used (See CAS 407); or
 - An average cost or pre-established rate for labor may be used if:
 - + The functions performed are not materially disparate and employees involved are interchangeable with respect to the functions performed, or
 - + The functions performed are materially disparate, but the employees involved either all work in a single production unit yielding homogeneous outputs or perform their respective functions as an integral team.
- When average cost or pre-established rates for labor are used, significant variances must be disposed of at least annually by reasonable proportion of costs previously allocated

CAS 418 – Homogeneous Indirect Cost Pools

- An indirect cost pool is homogeneous if:
 - Cost of significant activities included has a comparable “beneficial or causal” relationship to cost objectives as the cost of other activities included in the cost pool
 - The allocation of the costs of the activities in the pool result in an allocation to cost objectives which is not materially different from an allocation where the costs of the activities were allocated separately.
- An indirect cost pool is not homogeneous if:
 - Costs of all significant activities in the cost pool do not have the same or a similar beneficial or causal relationship to cost objectives, and
 - If the costs were allocated separately, the resulting allocation would be materially different.
 - The determination of materiality is made using the criteria provided in 9903.305.
- A homogeneous indirect cost pool shall include all indirect costs identified with the activity to which the pool relates

CAS 418 – Change in Allocation Base

- If CAS 418 criteria identify a different base to be used . . .
- No change in an existing indirect cost pool allocation base is required if the allocation resulting from the existing base . . .
- Yields cost allocations that do not differ materially from the allocation that results from the use of the base determined to be most appropriate under the CAS 418 criteria

CAS 418 – Criteria for Allocation Base #1

- Cost of management or supervision of Direct Labor or Direct Material cost must be allocated over a base representing the activity being managed:
 - A direct labor hour base or direct labor cost base shall be used, whichever in the aggregate is more likely to vary in proportion to the costs included in the cost pool being allocated, except that:
 - A machine-hour base is appropriate if the costs in the cost pool are comprised predominantly of facility-related costs, such as depreciation, maintenance, and utilities; or
 - A units-of-production base is appropriate if there is common production of comparable units; or
 - A material cost base is appropriate if the activity being managed or supervised is a material-related activity
- All significant elements of the selected base shall be included

CAS 418 – Criteria for Allocation Base #2

- Indirect cost pools that include material amounts of the costs of management or supervision of activities involving direct labor or direct material costs shall be allocated to:
 - Final cost objectives;
 - Goods produced for stock or product inventory;
 - Independent research and development and bid and proposal projects;
 - Cost centers used to accumulate costs identified with a process cost system (i.e., process cost centers);
 - Goods or services produced or acquired for other segments of the contractor and for other cost objectives of a business unit; and
 - Self-construction, fabrication, betterment, improvement, or installation of tangible capital assets.

CAS 418 – Criteria for Allocation Base #3

- Allocation measures for indirect cost pools that are not management or supervision of direct labor or direct material costs must be allocated using an appropriate measure of resource consumption:
 - The best representation is a measure of resource consumption
 - The next best representation is a measure of the output of the activities
 - When all else fails, find surrogate that varies in proportion to the services received.
- Allocation of indirect cost pools that benefit each other:
 - The cross-allocation (reciprocal) method,
 - The sequential method, or
 - Another method where the results approximate those achieved by either
- Where the activities represented by an indirect cost pool provide services to two or more cost objectives simultaneously, the cost of such services shall be prorated between or among the cost objectives in reasonable proportion to the beneficial or causal relationship between the services and the cost objectives.

CAS 418 – Special Allocation

- Where a particular cost objective in relation to other cost objectives receives significantly more or less benefit from an indirect cost pool than is reflected by the selected base
- The Government and contractor may agree to a special allocation from that indirect cost pool to the particular cost objective commensurate with the benefits received
- The agreed upon amount of a special allocation:
 - Adjusted out of the indirect cost pool, and
 - Adjust the cost objective's base data from the allocation base

CAS 418 – Pre-established Rates

- Pre-established rates, based on either forecasted actual or standard cost, may be used in allocating an indirect cost pool:
 - Must reflect the costs and activities anticipated for the cost accounting period
 - Need to be reviewed at least annually, and revised as necessary to reflect the anticipated conditions
 - The contracting parties may agree on pre-established rates which are not based on costs and activities anticipated for a cost accounting period
 - Must have and consistently apply written policies for the establishment of rates
 - Where variances of a cost accounting period are material, these variances shall be disposed of by allocating them to cost objectives in proportion to the costs previously allocated to these cost objectives by use of the pre-established rates
- If pre-established rates are revised during a cost accounting period and if the variances accumulated to the time of the revision are significant, the costs allocated to that time shall be adjusted to the amounts which would have been allocated using the revised pre-established rates

Polling Question #3

Relying on materiality is a low risk approach to defending allegations of noncompliance with CAS 418?

- True
- False
- Need more information



CAS 418 – Illustration #1

- Business Unit A has various classifications of engineers whose time is spent in working directly on the production of the goods or services called for by contracts and other final cost objectives.
 - In keeping with its written policy, detailed time records are kept of the hours worked by these engineers, showing the job/account numbers representing various cost objectives.
 - On the basis of these detailed time records, Unit A allocates the labor costs of these engineers as direct labor costs of final cost objectives.
 - This practice is in accordance with the requirements of CAS 418

CAS 418 – Illustration #2

- Business Unit B has a fabrication department, employees of which perform various functions on units of the work-in-process of multiple final cost objectives.
 - These employees are grouped by labor skills and are interchangeable within the skill grouping. The average wage rate for each group is multiplied by the hours worked on each cost objective by employees in that group.
 - The contractor classifies these costs as direct labor costs of each final cost objective.
 - This cost accounting treatment is in accordance with the provisions of CAS 418

CAS 418 – Illustration #3

- Business Unit E includes all the cost of occupancy in an indirect cost pool.
 - In selecting an allocation measure for this indirect cost pool, the contractor establishes that it is impractical to ascertain a measurement of the consumption of resources in relation to the use of facilities by individual cost objectives.
 - An output base, the number of square feet of space provided to users, can be measured practically; however, the cost to provide facilities is significantly different for various types of facilities such as warehouse, factory, and office requires a different level of resource consumption to provide the same number of square feet of usable space.
 - Allocation on a basic unit measure of square feet of space occupied will not adequately reflect the proportional consumption of resources.
 - Unit E establishes a weighted square foot measure for allocating occupancy costs, which reflects the different levels of resource consumption required to provide the different types of facilities.
 - This practice is in conformance with provisions of CAS 418

CAS 418 – Illustration #4

- Business Unit F has an indirect cost pool containing a significant amount of material-related costs.
 - The contractor allocates these costs between his machining overhead cost pool and his assembly overhead cost pool.
 - The business unit finds it impractical to use an allocation measure based on either consumption or output.
 - The business unit selects a dollars of material-issued base which varies in proportion to the services rendered.
 - The dollars of material-issued base is a surrogate base which conforms to the provisions of CAS 418

CAS 418 – DCAA Illustration #1

■ Problem

- An audit of contractor B reveals that several indirect cost pools contain costs of activities having dissimilar beneficial or causal relationships to cost objectives to which the pool is allocated.
- Further analysis indicates that allocation of the costs of the activities, included in the cost pool, result in an allocation to cost objectives which is not materially different from the allocation that would result if the costs of the activities were allocated separately.

■ Solution

- The contractor's practice is currently in compliance with CAS 418-50(b)(1). However, if it is expected that the practice will have a material impact in the future and the probability of this impact can be specifically commented upon, the situation should be reported to the cognizant CFAO.
- In addition, periodic follow-up audits should be performed to ascertain whether circumstances have changed the allocation differences from immaterial to material

CAS 418 – DCAA Illustration #2

■ Problem

- The base for allocation of overhead costs at contractor C is direct labor hours.
- Although contractor C's salaried employees work on the average 60 hours a week, only 8 hours per day and 40 hours per week are recorded on the employees' timesheets.
- Floor checks and employee interviews have revealed that the excess hours worked by salaried employees are, in many cases, incurred on cost type contracts in an overrun situation, bid and proposal costs in excess of the negotiated ceiling, and other fixed price and commercial work.

■ Solution

- Subject to the criteria of materiality, the contractor should be cited as being in noncompliance with CAS 418-50(d) in that the base selected to measure the allocation of the pooled costs to cost objectives is not a base representative of the activity being managed or supervised and all significant elements of the selected base have not been included.
- The contractor should be required to record excess hours worked by salaried employees and include all direct labor hours worked in the base for allocation of overhead costs. (See 6-410.)

CAS 418 – Exemptions

- CAS 418 does not apply to contracts and grants with state, local, and Federally-recognized Indian tribal governments

Fun Facts about CAS 418

- General Dynamics Corp – Trips on corporate aircraft based on the principal passenger
- Litton Systems, Inc. – Government did not prove average direct labor rates and composite overhead pools for two divisions was not compliant with CAS 418
- AM General LLC – Contractor did not establish a separate indirect cost pool for the costs of a building where commercial HUMMERS were completed (vacated in part on appeal)
- Sikorsky Aircraft Corp. – Allocation of supervision and material related to direct material costs over a direct labor base was acceptable under CAS 418 – the government failed to demonstrate noncompliance with CAS 418

Positioning for future sessions . . .

September 28th – 2:00 Eastern . . .

Episode 6 – Home Office Allocations – CAS 403

Government Contracting

Last Chance for Some Questions

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