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# Cost Principles, FAR Part 31 and Direct/Indirect Overhead 2023

Session 3: Going Deeper on Allocability

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# Agenda

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Recap

General Principles

Allocation Under the Cost Accounting Standards

Accumulation & Distribution



## RECAP

# Guiding Principles

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The FAR also articulates guiding principles for the federal acquisition system

- (a) satisfy the customer in terms of cost, quality, and timeliness of the delivered product or service ...;
- (b) minimize administrative operating costs;
- (c) conduct business with integrity, fairness, and openness; and
- (d) fulfill public policy objectives.

# FAR Part 31 Purpose

- Establish boundaries and parameters regarding allowable costs that can be negotiated and/or claimed under government contracts or subcontracts
- Key Philosophies Embedded in Cost Principles
  - Government does not want to share in costs that it does not cause nor derive a benefit from (“causal and beneficial”)
  - Equitable allocation or identification of costs to government contracts
  - Non-government programs should absorb their share of costs
  - Selected costs in FAR 31.205-XX identified as unallowable are theoretically not created by doing business with government, nor required to sustain contract performance

# CAS within the FAR

Most CAS requirements are included either in full or in part within FAR PART 31

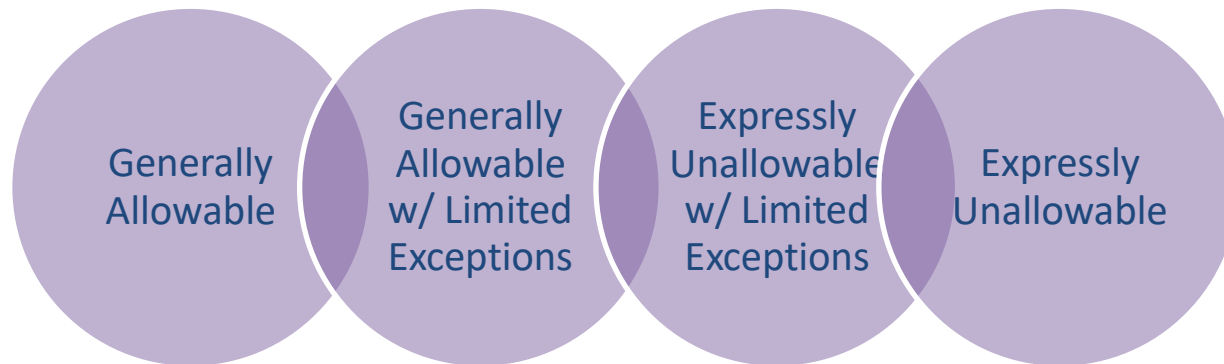
- CAS 401 – Consistency in Estimating, Accumulating, and Reporting Costs
- CAS 402 – Consistency in Allocating Costs Incurred for the Same Purpose
- CAS 405 – Accounting for Unallowable Costs
- CAS 406 – Cost Accounting Period
- CAS 407 – Use of Standard Costs for Direct Material and Direct Labor
- CAS 408 – Accounting for Compensated Personal Absence
- CAS 409 – Depreciation of Tangible Capital Assets
- CAS 410 – Allocation of Business Unit G&A Expenses to Final Cost Objectives
- CAS 414 – Cost of Money as an Element of the Cost of Facilities Capital
- CAS 415 – Accounting for the Cost of Deferred Compensation
- CAS 416 – Accounting for Insurance Costs.
- CAS 418 – Allocation of Direct and Indirect Costs

Biggest difference is that Full CAS Coverage triggers completion and filing of a Disclosure Statement. Any future changes would require determination of a cost accounting practice change and calculation of a cost impact

# Overview of FAR Part 31

## 31.205 – Selected Cost Principles

- 46 separate cost principles covering topics such as advertising, travel, consultants, interest, donations, employee morale, and entertainment
- All 46 cost principles can be logically grouped as follows:





## Expressly Unallowable Costs

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Certain costs are specified within 31.205 as expressly unallowable

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Alcoholic Beverages (31.205-51)

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Bad Debts (31.205-3)

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Contingency Provisions (31.205-7)

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Contributions and Donations (31.205-8)

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Entertainment (31.205-14)

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Fines and Penalties (31.205-15)

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Interest on Borrowed Capital (31.205-20)

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Lobbying Costs (31.205-22)

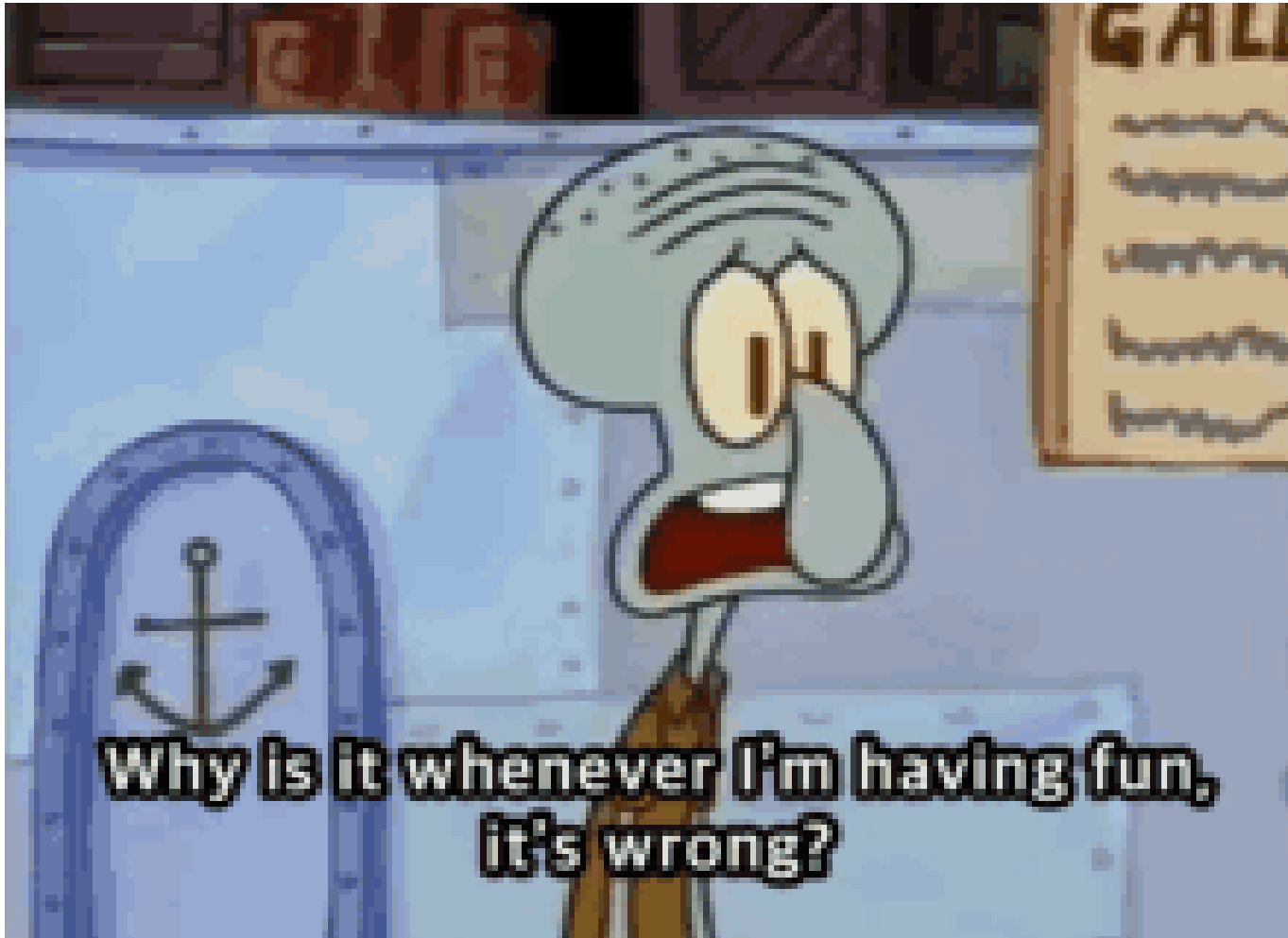
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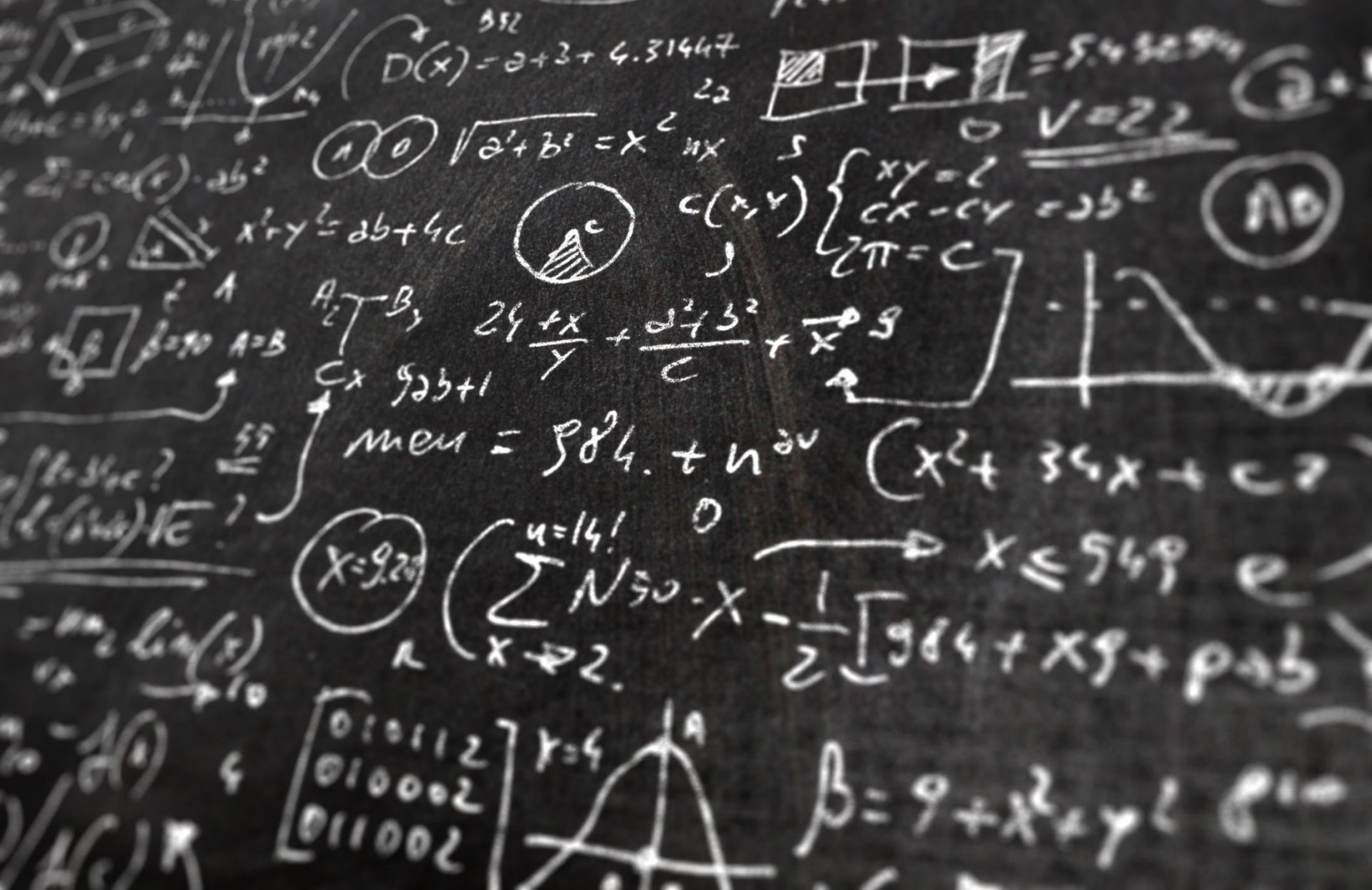
Organization Costs (31.205-27)

# Allowability

In order for a cost to be allowable it must comply all of these criteria:

- Reasonable
- *Allocable*
- Standards promulgated by CAS (where applicable) or generally accepted accounting principles (GAAP)
- Terms of the Contract
- Any limitations in subpart 31





## Basics of Allocation

## Indirect Rates Defined – Key Terminology

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**Allocation Base:** Measure of activity such as direct labor dollars used to calculate indirect expense rates and assign costs to cost objectives

**Direct costs:** Costs associated solely with a specific final cost objective

**Final cost objective:** Cost objective which has allocated to it both direct and indirect costs and is a final accumulation point in the accounting system – generally a contract

**Indirect costs:** Costs that cannot be identified to a particular final cost objective and that benefit more than one final cost objective

**Intermediate cost objective:** Cost objective, created for more accurate allocations, consisting of indirect costs that are ultimately allocated to final cost objectives

**Expense Pool:** Grouping of homogeneous costs identified with two or more cost objectives; numerator of rate calculation

**Indirect Rate:** Percentage result of dividing expense pool by allocation base

**Total cost input (TCI):** All costs, less general & administrative expenses; a common allocation basis for G&A and used in related rate calculation

# Indirect Costs

- After direct costs have been determined and charged directly to the contract or other work, indirect costs are those remaining to be allocated to intermediate or two or more final cost objectives.
- No final cost objective shall have allocated to it as an indirect cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included as a direct cost of that or any other final cost objective.
- The contractor shall accumulate indirect costs by logical cost groupings

# Indirect 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.
- The base selected shall allocate the grouping on the basis of the benefits accruing to intermediate and final cost objectives.
- ***When substantially the same results can be achieved through less precise methods, the number and composition of cost groupings should be governed by practical considerations and should not unduly complicate the allocation.***

# Indirect Costs

- Once an appropriate base for allocating indirect costs has been accepted, the contractor shall not fragment the base by removing individual elements.
  - All items properly includable in an indirect cost base shall bear a pro rata share of indirect costs irrespective of their acceptance as Government contract costs.
  - For example, when a cost input base is used for the allocation of G&A costs, the contractor shall include in the base all items that would properly be part of the cost input base, whether allowable or unallowable, and these items shall bear their pro rata share of G&A costs.
- The method of allocating indirect costs may require revision when there is a significant change in the nature of the business, the extent of subcontracting, fixed-asset improvement programs, inventories, the volume of sales and production, manufacturing processes, the contractor's products, or other relevant circumstances.



# Indirect Costs

- Separate cost groupings for costs allocable to offsite locations may be necessary to permit equitable distribution of costs based on the benefits accruing to the several cost objectives.
- A base period for allocating indirect costs is the cost accounting period during which such costs are incurred and accumulated for allocation to work performed in that period.
  - For contracts subject to full or modified CAS coverage, the CAS contractor shall follow the criteria and guidance in 406 for selecting the cost accounting periods to be used in allocating indirect costs.
  - For contracts other than those subject to CAS 406 of this section, the base period for allocating indirect costs shall be the contractor's fiscal year used for financial reporting purposes in accordance with generally accepted accounting principles.
    - The fiscal year will normally be 12 months, but a different period may be appropriate (*e.g.*, when a change in fiscal year occurs due to a business combination or other circumstances).

# Allocability

A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship.

A cost is allocable to a Government contract if it-

- Is incurred specifically for the contract (*But for rule*)
- Benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received (*Causal/Beneficial relationship*)
- Is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown (*G&A Expenses*)

# Allocability

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Helpful excerpts from CASB statement of objectives:

*“The basic premise of good cost accounting is that the measurement, assignment, and allocation of costs to cost objectives be based on the beneficial or causal relationship between those costs and the cost objectives. In defining the proper measurement, assignment, and allocation of cost, certain accounting concepts such as materiality, the choice of an appropriate accounting method, and full costing should be carefully considered.”*

*“The bases selected for allocating costs ... are the devices used to associate costs with final cost objectives... If the base selected is a reasonable measure of the relationship between the cost and cost objectives, the cost will be reasonably allocated to such cost objectives. The Board has referred to this conceptual relationship in the Standards as the beneficial or causal relationship ...”*

- A final cost objective can allocate to other cost objectives?
  - True
  - False

## Polling Question



## Cost Allocation Standards

# CAS 403

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## CAS 403 – Allocation of Home Office Expenses to Segments

- Segment definition: One of 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
  - Segments **DO NOT** have to align with legal entity structure
- Allocations should be based on the causal beneficial relationship between the cost and the final cost objectives
- Such 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
- Minimize to the extent practical the amount of expenses which may be categorized as residual (those of managing the organization as a whole)
- 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

# CAS 403

## Homogenous home office cost pools

- **Centralized service functions.** shall be allocated to segments on the basis of the service furnished to or received by each segment. Centralized service functions performed by a home office for its segments are considered to consist of specific functions which, but for the existence of a home office, would be performed or acquired by some or all of the segments individually. Examples include centrally performed personnel administration and centralized data processing.
- **Staff management of certain specific activities of segments.** The 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 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.

# CAS 403

## Homogenous home office cost pools

- **Central payments or accruals.** Central payments or accruals which are 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. Central payments or accruals are those which but for the existence of a number of segments would be accrued or paid by the individual segments. Common examples include centrally paid or accrued pension costs, group insurance costs, State and local income taxes and franchise taxes, and payrolls paid by a home office on behalf of its segments. Any such types of payments or accruals which 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.** Independent research and development costs and bid and proposal costs of a home office shall be allocated in accordance with 9904.420.
- **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.



# CAS 403

- Any remaining home office expenses are considered 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 such segments.
- A 3-factor formula shall be utilized for residual expenses if the total amount of such expenses for the contractor's previous fiscal year exceeds the amount obtained by applying the following percentage(s) to the aggregate operating revenue of all segments for such 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

# CAS 403

- Three-factor formula:
  - Segment % of payroll dollars
  - Segment % of operating revenue
  - Segment % of average net book value of assets
- Where a particular segment receives significantly more or less benefit from residual expenses than would be reflected by the allocation of such expenses the Government and the contractor may agree to a special allocation of residual expenses to such segment commensurate with the benefits received

# CAS 407

## CAS 407 – Standard Costs

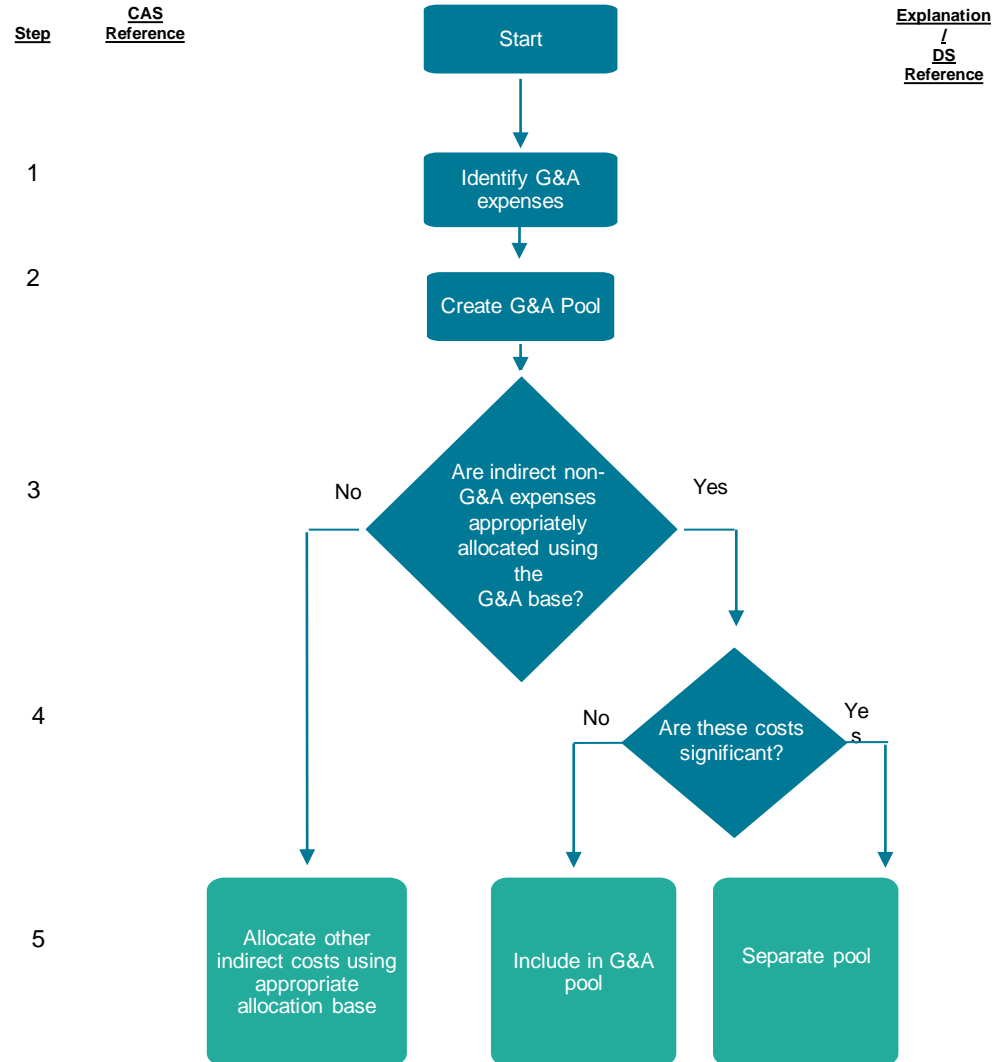
- Use of standard costs is acceptable under CAS if they are entered into the formal books and records of the contractor
- Standard costs and their related variances need to be accounted for at the production unit level
  - This “true-up” to actual is difficult for many commercial companies
- Contractor must have documentation of their practices
  - Creating the standard cost
  - Revising standards
  - Use of standards
  - Disposition of variance

# CAS 410

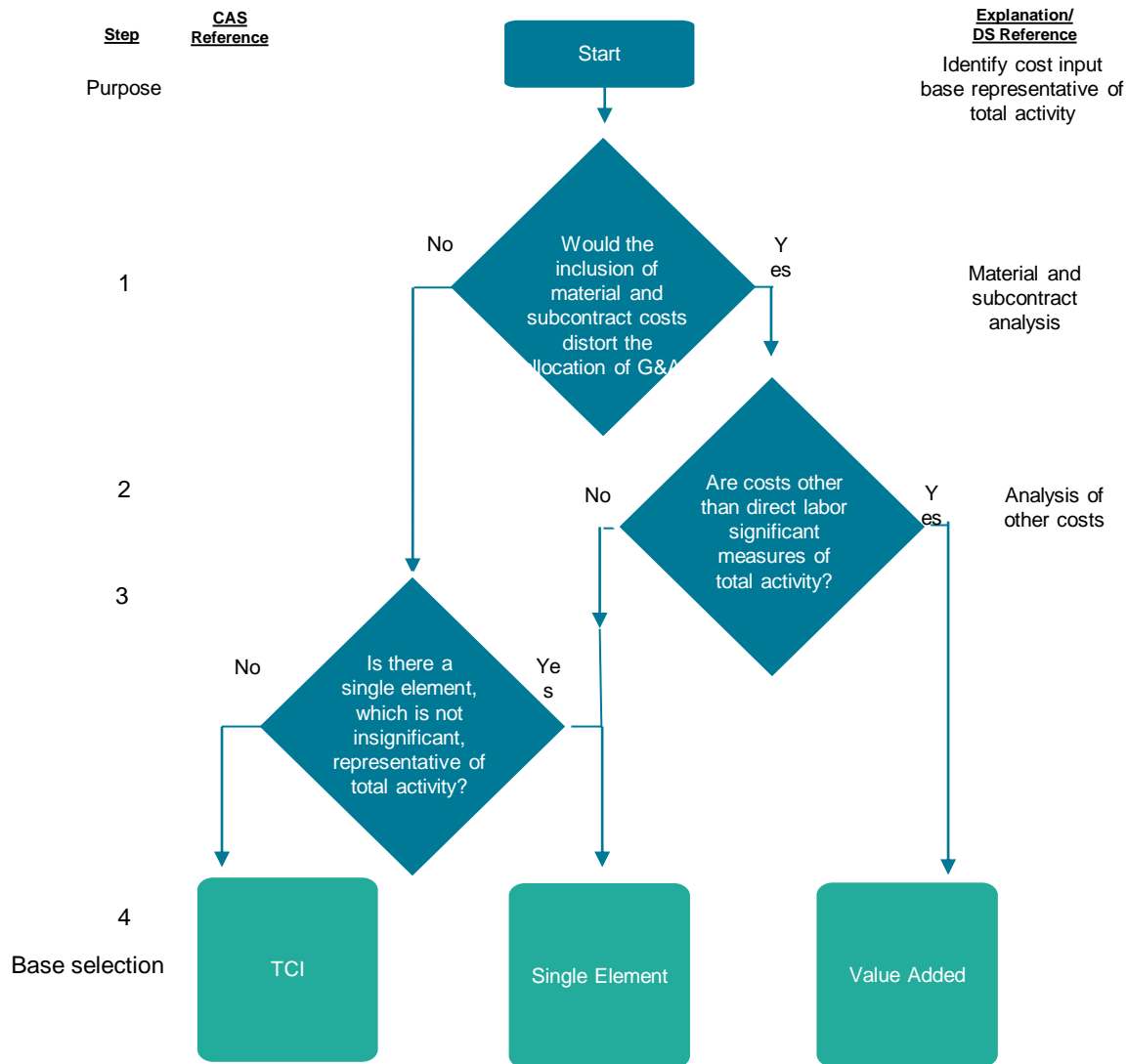
## CAS 410 – Allocation of Business Unit G&A Expenses to Final Cost Objectives

- Requires business unit G&A to be grouped into a single indirect cost pool and allocated to final cost objectives
- DCAA has a preference for a Total Cost input base but the standard allows for several options
  - Base should represent a causal beneficial relationship
  - Options include:
    - Total Cost Input (TCI) – (Total cost incurred, including unallowables, - general & administrative expenses)
    - Value Added (TCI as calculated above less direct materials and subcontracts)
    - Single Element (e.g., labor)

# G&A Expense Pool Flowchart



# G&A Allocation Base Flowchart



# CAS 418

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- CAS 418 – Allocation of Home Office Expenses to Segments

- Contractors must consistently determine whether costs are direct or indirect costs in a written policy
- Indirect costs must be accumulated in homogeneous cost pools
- Cost pools must be allocated on the basis casual beneficial relationship to final cost objectives
  - Where significant portions of the cost in the pool are management costs related to direct labor or direct material, the allocation base shall reflect that
  - If management is not a material cost in the pool, the base should reflect consumption or usage

# CAS 420

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## CAS 420 – Accounting for IR&D and B&P Costs

- IR&D and B&P should be captured in individual projects
- IR&D & B&P should receive indirect allocations except G&A
  - Overhead
  - Fringe
  - Other indirect allocations such as facilities
- IR&D is treated as a final cost objective and receives G&A allocation
- B&P is included in the G&A cost pool
- When IR&D is incurred at the home office, it should be charged to the segments (business) units on a causal/beneficial relationship



# CAS 420 – Bid & Proposal

- *In English please????*
  - Set up a B&P/IR&D project (like any other contract in your accounting system)
  - Charge all direct costs to the project and allocate all indirect cost as you would to a contract (except G&A)
  - Include the total cost for all B&P projects for the year, in the G&A pool or allocate in a separate pool using the G&A base
- ***Bottom line: Treat IR&D/B&P projects like any other contract UNTIL the allocation of G&A***

- CAS 403 allows all home office expenses to be treated as residual and allocated via the 3-Factor Formula.
  - True
  - False
  - It depends?

**Polling Question**

# Other Allocation Standards

# Other allocation standards

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## CAS 411 – Accounting for Acquisition Cost of Materials

- Contractors must have a written policy
- Two methods of charging material
  - Direct identification of the material item to a particular contract
  - Inventory
  - To allocate a cost directly to a contract, the final cost objective for the material must be identified at the time of purchase or production
  - Contractors can allocate a category of material directly even if it maintains the material in inventory, as long as the cost objective was specifically identified and the cost allocated at the time of purchase or production
  - Material could be allocated at different costs to the same cost objective, one cost by direct identification and one through issuance out of inventory.

# Other allocation standards

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# Other allocation standards

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## CAS 414 – Cost of Money as an Element of the Cost of Facilities Capital

- Establishes criteria for the measurement and allocation of the cost of capital committed to facilities as an element of contract cost
  - **Facilities capital** means the net book value of tangible capital assets and of those intangible capital assets that are subject to amortization
- The cost of money rate is the Secretary of the Treasury rate
  - Many contractors have not bothered with the COM factor because the rate is so low
  - May become more material/relevant due to inflation
- Calculate the cost of capital for each contract by applying the cost of money factor to the net book value of assets assigned to the contract

# Other allocation standards

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## CAS 416 – Accounting for Insurance Costs

- The amount of insurance cost to be assigned to a cost accounting period is the [projected average loss](#) for that period plus [insurance administration expenses](#) in that period.
- The allocation of insurance costs to [cost objectives](#) shall be based on the beneficial or casual relationship between the insurance costs and the benefiting or causing [cost objectives](#).
- Insurance may be purchased or self insured
  - Purchased insurance calculations generally straight forward
  - Generally, self-insurance calculations require annual actuarial analysis to calculate projected average cost

# ACCUMULATION & DISTRIBUTION



# Accumulation of Costs

- Government contractors must accumulate costs in a logical & consistent manner
  - Direct costs charged to contracts, i.e., project codes
  - Indirect costs are grouped together with like costs into pools
- In practice, this means government contractors may have different accounting system needs than their commercial counterparts
  - Job cost system which gathers costs at the intermediate and final cost objective level
  - General ledger structure which supports different account types, i.e., unallowable, overhead, G&A

# Distribution of Costs

- Once indirect costs are gathered in homogenous pools, contractors must spread or distribute them to final cost objectives
- This is called “allocation”, i.e., identifying the proportion of non-direct expenses that each project should bear
  - The process requires dividing the pooled case by a base, creating a proportion, i.e., the indirect rate
  - The base or denominator of your proportion should reflect the benefits of the pool to the contract or project. In cost allocation, this is also known as a “driver”
  - The calculation is the same for all indirect cost pools: divide the total collected in the overhead, G&A or fringe pool by an appropriate allocation base.
- Use an allocation base that reflects the relationship between the allocation base and the cost pool
- Different pools will have different allocation bases

- A total cost input base is preferred by DCAA when allocating G&A.
  - True
  - False
  - It depends on the whim of the auditor?

### Polling Question

# Next Session

- Calculating indirect rates
- Rate structures
- Indirect rates throughout the contract life cycle

QUESTIONS?

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