

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

Session 5: Direct Costs

Jennifer Flickinger

Partner, HKA



Agenda

- Recap
- Direct Costs
- Timekeeping
- DCAA Audits



RECAP

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

Indirect Rates Defined – Key Terminology

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

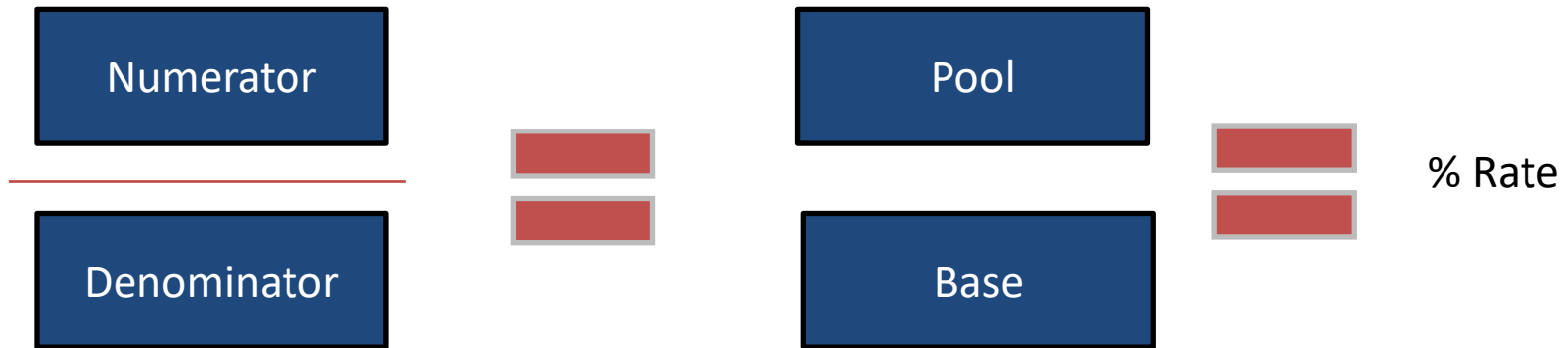
Allocability

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*)

Rate Pool Basics



- If the base is steady but the pool decreases, the rate
- If the pool is constant and the base decreases, the rate



More Complex Structures

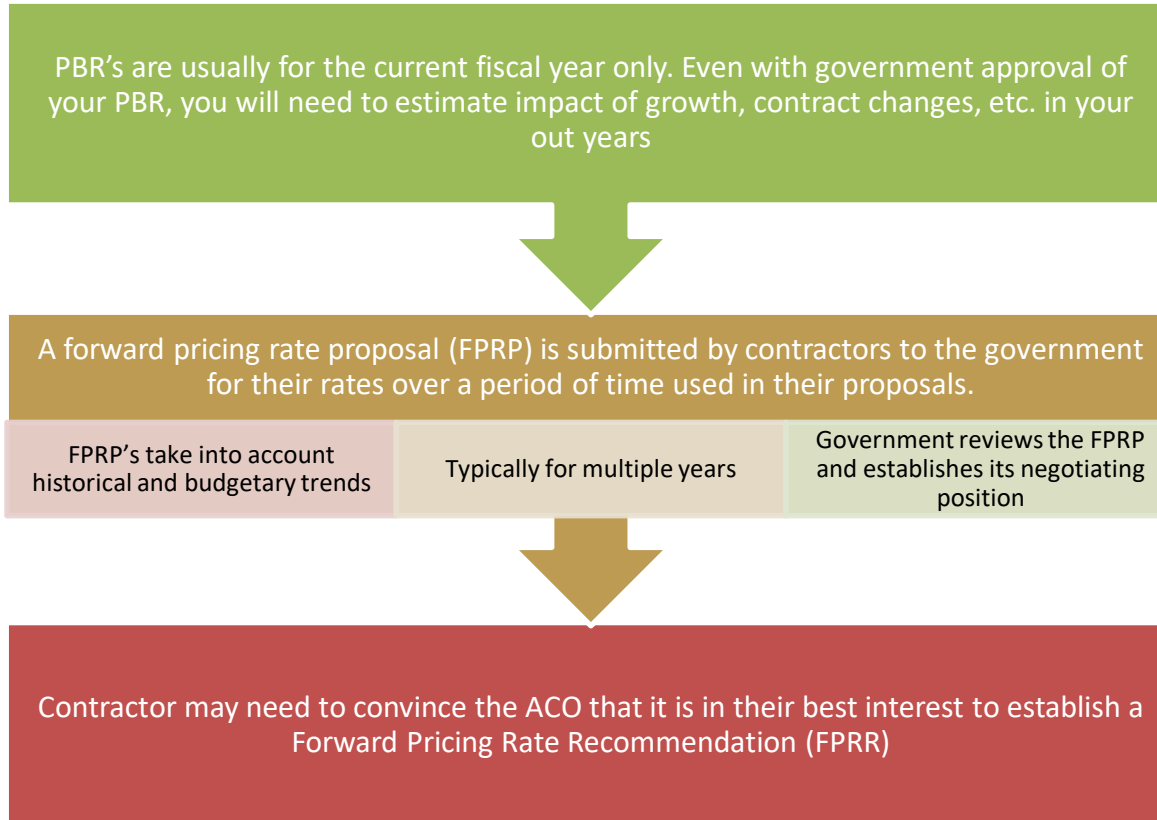
- As company's grow, they often implement more complex structures
- Complexity can be driven by types of products/services, locations, etc.
- Common examples include:
 - Creation of an IT pool
 - Allocation represents Usage (may allocate over # of devices)
 - Costs include personnel, telephone, internet, web services, etc.
 - Creation of facilities pool
 - Allocation typically represents usage, i.e., SF
 - Costs include personnel, rent, depreciation, maintenance, utilities, etc.
 - Other sample service centers include payroll, transportation, security, etc.
 - Multiple overhead rates
 - Multiple fringe rates

More Complex Structures

Guiding Principles

- KISS (Keep it simple stupid) and make sure you have the systems to support your allocations
- Align your general ledger structure with your rate structure
- Make sure your base and pool structures are easily identifiable and segregable
- Make sure you're the size of your base and pool is large enough to be stable. Too small of a base can lead to volatile indirect rates
- Align your rate structure with how you do work
- Do not change your rate structure for one contract

PBR vs Forward Pricing Rate Proposal



DIRECT COSTS

Composition of Total Contract Costs



Direct Costs Definition

“No final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for the same purpose in like circumstances have been included in any indirect cost pool to be allocated to that or any other final cost objective. Direct costs of the contract shall be charged directly to the contract. All costs specifically identified with other final cost objectives of the contractor are direct costs of those cost objectives and are not to be charged to the contract directly or indirectly.”

Direct Costs

- Can be identified with an individual final cost objective
 - Contract
 - Internal Project
- How can identify a direct cost?
 - Does the cost result in a direct benefit to the program?
 - Can it be easily and accurately traced to the program?
 - Does it benefit only one program?
 - Is it normally charged as indirect?

Other Direct Costs

- Direct costs are more than labor & materials
- ODC's are NOT actually defined in the FAR
- So what are ODC's?

An ODC is a cost that can be identified specifically with a final cost objective that is not treated as either a direct material or direct labor cost

ODC Examples

Travel

Special Tooling

Test Equipment

Packaging

Computer Services

Consultants

Direct Cost Challenges

- “if other costs incurred for the same purpose in like circumstances have been included in any indirect cost pool to be allocated to that or any other final cost objective”
- Like purpose? What does this mean?
 - Generally, you cannot charge a cost to a contract as both a direct and indirect costs

Example – Cost Incurred for Same Purpose

- Contractor normally allocates all travel as an indirect cost and previously disclosed this accounting practice to the Government.
- For purposes of a new proposal, contractor intends to allocate the travel costs of personnel whose time is accounted for as direct labor directly to the contract.

Polling Question

- On the previous slide, the BD team wants to charge travel costs direct. Can the contractor continue to charge travel costs on an indirect Basis?
- Yes
- No

What would the contractor be required to do?

- Since travel costs of personnel whose time is accounted for as direct labor working on other contracts are costs which are incurred for the same purpose, these costs may no longer be included within indirect cost pools for purposes of allocation to any covered Government contract.
- Contractor's Disclosure Statement must be amended for the proposed changes in accounting practices

Example – Costs Incurred for Differing Purposes

- Contractor normally allocates special tooling costs directly to contracts. The costs of general purpose tooling are normally included in the indirect cost pool which is allocated to contracts. Both of these accounting practices were previously disclosed to the Government.

Polling Question

- Is the contractor's practice of having general tooling charged on an indirect basis and special tooling charged direct?
 - Yes
 - No

Costs Incurred for Differing Purposes

- The general tooling and special tooling were incurred for DIFFERENT purposes, therefore, the differing cost accounting practices are ok?
- Other examples, a company has a general security force for protection of a building. This cost is charged indirectly. The company has one classified contract which requires a SCIF. The charges for maintaining, supporting and securing the SCIF are charged direct.

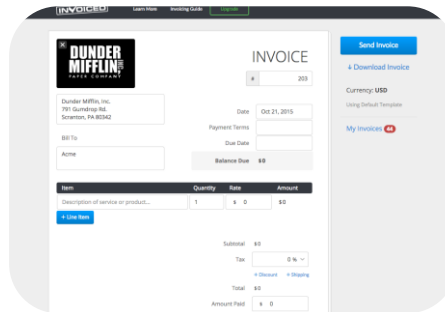
Direct Costs Best Practices

- Define your disclosed practices
 - Keep flexibility in mind especially regarding growing service lines
 - Address differing circumstances up front in your proposal Basis of Estimate

Supporting Documentation for Direct Costs



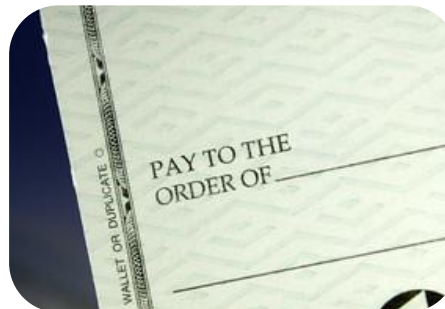
Timesheet



Invoice



Receipt



Proof of Payment

Supporting Documentation Issues

- Lack of “original” records
 - DCAA sometimes takes issue with electronic records
 - Seems to be ignoring its own FAR Guidance:
 - FAR 4.703(c) “original records need not be maintained or produced in an audit if the contractor or subcontractor provides photographic or electronic images of the original records and meets the” three criteria listed there
 - FAR 4.703(d), which allows contractors to maintain records on computers.
 - Have a policy which states that electronically submitted receipts, invoices, etc. are considered the company’s original records

Supporting Documentation Issues

- Inability to find documents
 - Utilize ERP capabilities to store POs, invoices, etc. with the transaction
 - DON'T allow people to store things on hard drives, etc.
 - Have a clear storage hierarchy
- Specific cost principal requirements, i.e., consultant cost principal
 - Details of all agreements
 - Invoices or billings
 - Consultant work product and related documents

TIMEKEEPING

Timekeeping

- Labor is the most significant cost in most service contracts. The underlying timekeeping policies, procedures and records are subject to significant scrutiny by the government
- The government's main criteria for adequate practices are grounded in manual timekeeping practices
- The guidance has not changed and the government still references DCAA Contract Audit Manual, Chapter 5-900

Timekeeping Requirements

- Timekeeping procedures should be in writing
- Instruction to each employee should be demonstrated
 - Distribution of a written procedure
 - Training material
 - Training Records
- Employees must personally record their time on timesheets
 - Exception, temporary circumstances (e.g. sick, pay period end, payroll cutoff)
 - Otherwise, completion of timesheets by supervisors or administrative staff is unacceptable
 - Policy must support exceptional circumstances

Timekeeping Requirements

- Timesheets should be completed daily
- All hours worked should be recorded (Total time Accounting)
- For manual timesheets:
 - Employees must record their time in ink.
 - Corrections must be made by crossing out the incorrect charge and inserting the correct one. No erasure or “white-outs” are allowed. All corrections must be initialed by both the employee and supervisor
 - Pre-printed timesheets with employee names should be used and distributed at set intervals (e.g. monthly)
- Employees and supervisors must sign timesheets certifying the accuracy of the recorded labor effort





Timekeeping Requirements

- When there is the potential for significant mischarging (e.g. large mix of commercial versus government contracts, multiple tasks performed by numerous people, etc.) start and stop times for recording time should be recorded
- Periodic internal review to ensure the procedures are being followed.
 - Verification of approved signatures
 - Reconciliation of time charges to job cost reports, labor distribution and payroll records
 - Periodic floor checks that verify jobs charged are the jobs actually worked

Electronic Timekeeping

- Limited guidance with regard to electronic timekeeping systems
- DCAM Chapter 5-909.2, “Automated Timekeeping Systems”
 - Auditors should make sure automated systems provide for accurate and timely recording of labor hours by authorized employees
 - Sufficient internal controls in place to ensure corrections to labor charges are accurate and appropriately authorized
 - Only employees have access to the labor system
 - If badges are used, there is no duplication of badge numbers, they are not issued to unauthorized persons and procedures are in place to quickly report lost badges
 - Changes are initialed and dated by the employee and supervisor and include a description of the reason for the change
 - A “verifiable audit trail process is in place that collects all initial entries and subsequent changes”

Total Time Accounting

- Total time accounting (TTA) is where each employee enters time for all actual hours worked regardless of whether they are paid for overtime or whether they are billable
 - Results in the calculation of a productive hourly rate
 - \$65,000 salary  2080 hours  \$31.25 Hourly Rate
 - \$65,000 salary  2200 hours  \$29.55 Hourly Rate
- DCAA's position is that all hours worked are needed to correctly determine the proper assignment of labor costs to contracts
 - Would be unfair for a contractor to record the first billable 8 hours of their day and not the next 3 non-billable
- February 2021 ASBCA Raytheon decision concluded that TTA was not required due to the company's established policies and procedures.
- January 2022, the U.S. Court of Appeals for the Federal Circuit (Fed. Cir.) reversed the ASBCA decision supporting the position that "after hours" worked should not be disregarded

Timekeeping Challenges

- Let's be honest, it stinks. It's administrative work, it's not fun and no one wants to do it, especially executives
- It is adverse to the culture of many commercial companies
 - Technically, everyone must do total time accounting. However, many companies utilize an exception policy for exempt executives who charge only one indirect code. Their timesheets may reflect 8 hours each day with only vacation, sick and unallowable (i.e., M&A) time recorded
 - No way to avoid for direct employees
- Remote employees and DCAA floorchecks
 - You do not have to provide home addresses or employee confidential information
 - Make arrangements for a phone or video call
 - Have a remote work policy which defines:
 - who is eligible to work remotely
 - clearly identify how employee performance is monitored and measured
 - Verification of employees actually performing work

Polling Question

Total Time Accounting is required?

- True
- False

COMMON DCAA AUDITS

Floor Checks (MAAR 6)

Purpose:

- Verify the existence of employees who bill to the contract;
- Evaluate timekeeping internal control procedures;
- Evaluate the accuracy of labor hour charges to the contract
- Note: these are UNANNOUNCED

Floor Checks (MAAR 6)

During these audits, DCAA auditors may:

- Interview or floor check employees at their work site, with an unannounced visit
- Discuss and observe work to determine whether employees are performing in the proper labor categories and charging time correctly
- Review timekeeping procedures to determine compliance with the contract
- Reconcile observations on employees' labor charges with payroll records, and follow up on any discrepancies
- Trace labor charges to contract requirements

Material Cost Audits (MAAR 13)

Purpose:

- Verify purchased materials were received
- Purchased materials were needed for the contract
- Purchases were reasonable in quantity and Price
- Properly accounted for initially and during any transfers in/out

Floor Checks (MAAR 6)

During these audits, DCAA auditors may:

- Use a sample of materials charged to a government contract and physically locate all items in the sample
- Obtain purchase orders for the sampled items and trace the purchase orders to receiving reports
- Compare purchase orders to contract requirements and/or bills of materials
- Verify that purchases were made at optimal quantities

Other Audits of Direct Costs

- Voucher reviews
- Incurred cost audits
 - Direct costs are included because:
 - the government needs to verify the completeness and accuracy of the contractor's total costs to avoid double-counting
 - direct costs are the most common means by which contractors allocate indirect costs to contracts
 - BUT, the indirect cost rate proposal is not a claim for direct costs incurred and billed during contract performance
- Contract Closeout Audits

Next Session

- Cost Analysis vs Price Analysis
- When are cost and price analysis required
- How to perform cost and price analysis
- Documenting cost and price analysis

QUESTIONS?

jenniferflickinger@hka.com