

Overcoming FAR Accounting System Challenges: What Growing Businesses Need to Know

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Perhaps one of the toughest challenges facing small and medium-sized U.S. federal contractors is setting up and implementing an accounting system that satisfies requirements imposed by the Federal Acquisition Regulation (FAR). The essential purpose of government oversight, with respect to contractor accounting systems, is to enable the government to effectively perform its due diligence in evaluating contractor pricing. So what do you need to know and how can you be prepared to meet these challenges and even a government audit?

Contractor pricing review determined by type of contract.

The timing of government due diligence in evaluating contractor pricing is triggered according to the type of contract. There are three basic types of government contracts, with variations on each.

Fixed-Price Contracts: The contractor and the government agree on pricing on the front end with government due diligence in evaluating such pricing done prior to contract award.

Time & Materials Contract: For T&M contracts the contractor and the government agree on billing rates for various labor categories on the front end; however, there may be other direct costs which are unknown until after they have been incurred. The government conducts its due diligence on labor pricing categories on the front end, but may audit hours billed against time sheets and other direct costs and allocated indirect costs after such costs have been incurred.

Cost-Reimbursement Contracts: The contractor is reimbursed costs plus any agreed upon fees. Direct costs are billed as actual, with indirect costs billed using a provisional rate. The final pricing on cost-reimbursement-type contracts is unknown until all of the costs have been recorded in the contractor's books and government due diligence has been performed.

FAR clause 52.216-7

Many T&M and all cost reimbursement contracts will contain FAR clause 52.216-7 (the allowable cost and payments clause). This clause requires the contractor to submit an adequate incurred cost submission within six months following the end of the contractor's year. As part of the government's due diligence in selecting contractors for the award of these types of contracts, the government will determine whether the contractor has an accounting system capable of accumulating costs on government contracts, and thus is capable of submitting such an incurred cost report. The contracting officer may seek to verify with the Defense Contract Audit Agency (DCAA) that the contractor's accounting system has been certified as adequate, or may seek some other form of assurance (such as an independent auditor's report) with respect to the adequacy of the contractor's accounting system.

What is DCAA and what should I know?

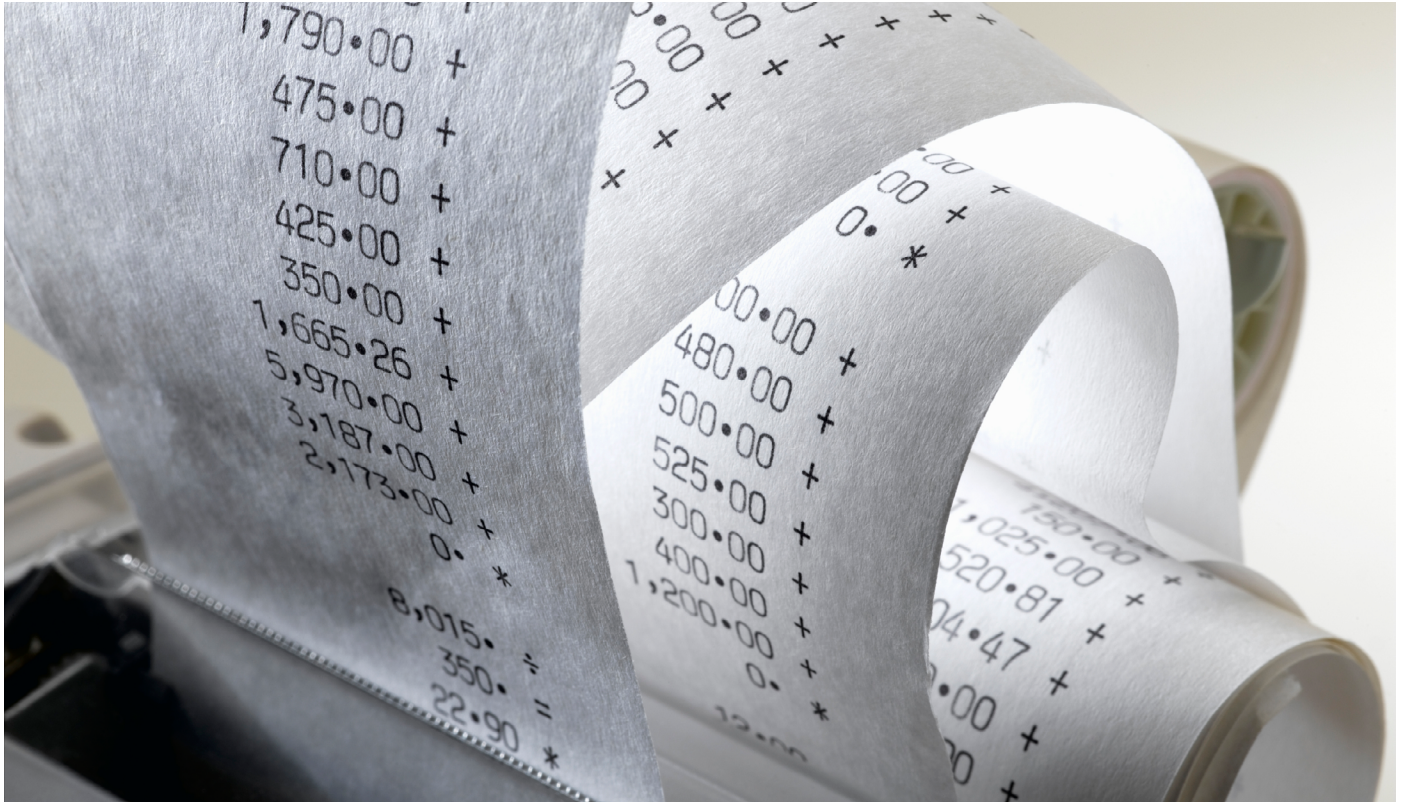
DCAA provides audits for various government agencies. Anyone who seeks to or is providing services to the federal government would do well to know what information DCAA needs and how best to provide that information. DCAA provides a publication called Information for Contractors, which contains a chapter on how they evaluate a prospective contractor's accounting system. This publication is available on the DCAA website (www.dcaa.mil). At the end of that chapter there is SF1408, which is a checklist and questionnaire that is used by DCAA when conducting accounting system evaluations.

How can I prepare for a review or audit?

To properly prepare for an accounting system evaluation pursuant to SF1408, whether it is to be conducted by DCAA, a civilian agency auditor or an independent auditor, the contractor needs to carefully consider the design and operation of their accounting system. It should be emphasized that the software application used by the



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contractor is only a part of the overall accounting system, and on its own, accounting software will not enable the contractor to pass such an accounting system review. The contractor must begin with written policy and procedure statements addressing certain internal controls and issues relevant to adherence to generally accepted accounting principles, segregation of direct costs from indirect costs, cost accounting, time keeping, labor distribution, contract cost reporting, and accounting for unallowable costs. The contractor must also address billing, budgeting and indirect cost allocation with its policy and procedure statements.

What software works?

With respect to your accounting software, there must be a general ledger based system in which costs are accumulated under general ledger control. The chart of accounts within this general ledger must demonstrate that direct costs are segregated from indirect costs. If indirect costs are appropriately organized into specific cost pools, then the chart of accounts should be organized consistent with the specific indirect cost pools established pursuant to the written policy statement.

Timekeeping system is essential.

A timekeeping system that adheres to the written timekeeping policy and addresses system requirements as specified in the DCAA publication Information for Contractors. A key provision in an acceptable timekeeping policy is the emphasis placed on the employee's

independent responsibility to maintain his own timesheet. It is perfectly acceptable for a contractor to maintain a manual timekeeping system; however, there are numerous web-based electronic timekeeping systems on the market that contain all of the internal controls necessary to maintain an acceptable timekeeping system. A beneficial feature of most (if not all) of these web-based timekeeping systems is the ability to transfer timekeeping data into the contractor's accounting software database so that the data is readily usable for both labor distribution and for billing.

Distribution of labor costs.

One requirement that most small business government contractors find daunting is the requirement to distribute labor costs pursuant to how time is reported on the timesheets. It cannot be emphasized enough the importance of tackling this task effectively. Direct labor must be distributed to the final cost objectives and the indirect labor must be distributed to the various indirect accounts. Accuracy in this detail oriented task impacts the job cost reporting and has a direct impact on the allocation of the indirect costs to intermediate and final cost objectives.

Detail job costs and indirect cost allocation.

The contractor must maintain job cost detail within its accounting system that reconciles back to general ledger control accounts. This seems to be a standard capability



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of most accounting software packages that are available on the market. However, an important capability which is not readily available in most accounting software packages is the ability to allocate indirect costs utilizing the indirect cost allocation bases established in the contractor's policy statements. Consequently, contractors will find that they need to go outside of the accounting software to perform this required function. Indirect cost allocation can be a complex process if done manually utilizing spreadsheet software, although that method is certainly acceptable. There are also add-on applications available which can automate this task for certain accounting software packages. By accumulating direct costs by job, and then allocating the indirect costs, the contractor is essentially satisfying the requirement to determine costs charged to contracts through the routine posting of the books of account.

Importance of budgeting function.

One often overlooked, but critically important characteristic of a compliant accounting system is the budgeting function. The contractor must demonstrate that costs and billings are tracked against budgeted and funding thresholds. The contractor must also demonstrate the ability to generate reasonable estimates for establishing

provisional indirect rates to be used in billing cost-reimbursement type contracts and in forward pricing agreements. A properly developed budget is based on recent actual activity, adjusted for reasonable assumptions for changes expected in the operation of the business.

To successfully compete for and manage government contracts, your company must have an accounting system and processes in place that meet government requirements. While some of the requirements may seem challenging, there are ready solutions like software that can be added to your existing system and accounting professionals who are well-versed in accounting system requirements and procedures rooted in the Federal Acquisition Regulation. Being proactive with upgrades to your system, the latest software and even your processes that offer compliancy to DCAA will enhance your overall efficiency. These changes can make your company more attractive to prospective partners and open doors for you and your team to compete on larger contracts.

Robert C. Smith is a CPA and CEO of ICAT Systems, which specializes in providing government contractors with the tools and understanding needed to meet DCAA requirements.

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