Chapter 8

Cost Accounting Standards

Table of Contents

8-000 - Cost Accounting Standards

8-001 Scope of Chapter

8-100 Section 1 – Introduction to Cost Accounting Standards

8-101 Introduction to Cost Accounting Standards

8-102 Background of Cost Accounting Standards Board

8-102.1 Establishment of Cost Accounting Standards Board (CASB)

8-102.2 CAS Working Group

8-102.3 Current Status of CAS - Recent Substantive CASB Promulgations

8-103 CAS Coverage Requirements and CAS Exemptions

8-103.1 Educational Institutions - CAS

8-103.2 CAS Exemptions

8-103.3 Types of Coverage

8-103.4 Effect of Contract Modifications

8-103.5 Effect of Basic Ordering Agreements

8-103.6 Effect of Letter Contracts

8-103.7 CAS Flowdown Clause - FAR 52.230-2

8-103.8 Submission of Disclosure Statement

8-103.9 Additional Exemptions on a Particular Standard

8-103.10 CAS Waivers

8-104 CAS Audit Responsibility

8-104.1 Basic Functions

8-104.2 Auditor's Function on Subcontracts Subject to CAS8-104.3 Contract Audit Coordinator (CAC)

8-104.3 Contract Audit Coordinator (CAC)

Figure 8-1-1 -- CAS Coverage and Disclosure Statement Determination

8-200 Section 2 – Disclosure Statement Adequacy

8-201 Introduction to Adequacy

8-300 Section 3 – Audits of Compliance with Cost Accounting Standards Board (CASB) Rules, Regulations, and Standards, and with FAR

8-301 Introduction

8-302 Noncompliance with CAS

8-302.1 Requirements

8-302.2 Types of Noncompliance

8-302.3 Compliance Considerations

8-302.4 Discussions with the CFAO and the Contractor

8-302.5 Coordination for Consistent Treatment

8-302.6 CAS Coordination in CAC/CHOA/GAC Complexes

8-302.7 Reporting CAS Noncompliance

8-302.8 Reporting FAR Noncompliance

8-303 Audit of Disclosure Statement and/or Established Practices to Ascertain Compliance with CAS and FAR

8-303.1 Requirements

8-303.2 Initial Audits of Compliance

8-303.3 Changes to Disclosure Statements and/or Established Practices

8-304 Audit of Estimated, Accumulated, and Reported Costs to Ascertain Compliance with CAS and FAR

8-304.1 Requirements

8-304.2 Compliance Audits

8-304.3 Reporting of Compliance Audit Results

8-400 Section 4 - Cost Accounting Standards

8-401 Cost Accounting Standard 401 - Consistency in Estimating, Accumulating and Reporting Costs

8-401.1 Consistency between Estimating and Accumulating Costs

8-401.2 Consistency in Reporting Costs

8-401.3 Illustrations

8-402 Cost Accounting Standard 402 - Consistency in Allocating Costs Incurred for the Same Purpose

8-402.1 Illustrations

8-403 Cost Accounting Standard 403 - Allocation of Home Office Expenses to Segments

8-403.1 General

8-403.2 Guidance

8-404 Cost Accounting Standard 404 - Capitalization of Tangible Assets

8-404.1 General

8-404.2 Assets Acquired in a Business Combination Using the Purchase Method of Accounting

8-404.3 Illustrations - Compliance with the Standard

8-404.4 Illustrations - Applicability Date of Amended CAS 404/409, Effective April 15, 1996

8-405 Cost Accounting Standard 405 - Accounting for Unallowable Costs

8-405.1 General

8-405.2 Illustrations

8-406 Cost Accounting Standard 406 - Cost Accounting Period

8-406.1 General

8-406.2 Restructuring Costs

8-407 Cost Accounting Standard 407 - Use of Standard Costs for Direct Material and Direct Labor

8-407.1 General

8-407.2 Illustrations

8-408 Cost Accounting Standard 408 - Accounting for Costs of Compensated Personal Absence

8-408.1 General

8-408.2 Illustrations

8-409 Cost Accounting Standard 409 - Depreciation of Tangible Capital Assets

8-409.1 General

8-409.2 Illustrations

8-410 Cost Accounting Standard 410 - Allocation of Business Unit General and Administrative Expenses to Final Cost Objectives

8-410.1 General

8-410.2 Illustrations

8-411 Cost Accounting Standard 411 - Accounting for Acquisition Costs of Material

8-411.1 General

8-411.2 Illustration

8-412 Cost Accounting Standard 412 - Composition and Measurement of Pension Costs

8-412.1 General

8-412.2 Assignment of Pension Cost

8-412.3 Full Funding Limitation

8-412.4 Nonqualified Plans

8-412.5 Illustrations

8-413 Cost Accounting Standard 413 - Adjustment and Allocation of Pension Cost

8-413.1 General

8-413.2 Segment Accounting

8-413.3 CAS 413.50(c)(12) Adjustment For Segment Closing, Plan Termination or Benefit Curtailment

8-413.4 Illustrations

8-414 Cost Accounting Standard 414 - Cost of Money as an Element of the Cost of Facilities Capital

8-414.1 General

8-414.2 Interest Rates – Cost of Facilities Capital

8-414.3 Evaluating the Contractor's Computations

8-415 Cost Accounting Standard 415 - Accounting for the Cost of Deferred Compensation

8-415.1 General

8-415.2 Illustrations

8-416 Cost Accounting Standard 416 - Accounting for Insurance Cost

8-416.1 General

8-416.2 Guidance

8-416.3 Illustrations

8-417 Cost Accounting Standard 417 - Cost of Money as an Element of the Cost of Capital Assets Under Construction

8-417.1 General

8-417.2 Guidance

8-417.3 Illustrations

8-418 Cost Accounting Standard 418 - Allocation of Direct and Indirect Costs

8-418.1 General

8-418.2 Guidance

8-418.3 Illustrations

8-419 Reserved

8-420 Cost Accounting Standard 420 - Accounting for Independent Research and Development Costs and Bid and Proposal Costs (IR&D and B&P)

8-420.1 General

8-420.2 Guidance

8-420.3 Illustrations

8-500 Section 5 - Cost Impact Proposals

8-501 Introduction

8-502 General - Cost Impact Proposals

8-502.1 CAS Clause Requiring Price Adjustments

8-502.2 FAR Requirement for Submission of Cost Impact Proposal

8-502.3 Accounting Practice Changes Related to External Restructuring

8-502.4 Cost Impact Proposal Data Requirements
8-502.5 Adequacy of Cost Impact Proposals
8-502.6 Audit of Cost Impact Proposals
8-502.7 Inclusion of Implementation Costs
8-502.8 Noncompliance with FAR Part 31
8-503 Guidance on Evaluation of Cost Impact Proposals
8-503.1 Five-Step Process to Calculate Cost Impact
8-503.2 Interest
8-503.3 Offsetting Cost Impacts
8-504 Failure to Submit Cost Impact Proposals
8-505 Conferences and Reports on Audits-Cost Impact Proposals
8-506 Coordination

8-000 - Cost Accounting Standards **

8-001 Scope of Chapter **

This chapter presents guidance for implementing DCAA responsibilities in connection with the Cost Accounting Standards Board (CASB) Rules, Regulations, and Standards. The CASB Rules, Regulations and Standards (48 CFR Chapter 99) are included in the FAR as Appendix, Cost Accounting Preambles and Regulations, and are available as AP-1 and AP-2 on the Hill Air Force FARSite.

8-100 Section 1 - Introduction to Cost Accounting Standards **

8-101 Introduction to Cost Accounting Standards **

This section provides the legal background and purposes of implementing the Cost Accounting Standards, including the rules and regulations, and audit responsibilities in implementing Section 26 of the Federal Procurement Policy Act, Public Law 100-679 (41 U.S.C. 1501-1506, formerly 41 U.S.C. 422).

8-102 Background of the Cost Accounting Standards Board **

8-102.1 Establishment of Cost Accounting Standards Board (CASB) **

a. The original CASB was established in 1970 as an agency of Congress in accordance with a provision of Public Law 91-379. It was authorized to (1) promulgate cost accounting standards designed to achieve uniformity and consistency in the cost accounting principles followed by defense contractors and subcontractors under Federal contracts in excess of $100,000 and (2) establish regulations to require defense

contractors and subcontractors, as a condition of contracting, to disclose in writing their cost accounting practices, to follow the disclosed practices consistently and to comply with duly promulgated cost accounting standards.

b. The original CASB promulgated 19 standards and associated rules, regulations and interpretations. It went out of existence on September 30, 1980.

c. On November 17, 1988, President Reagan signed Public Law 100-679

which reestablished the CASB within the Office of Federal Procurement Policy (OFPP), which is under the Office of Management and Budget (OMB). The CASB consists of five members: the Administrator of OFPP who is the Chairman and one member each from DoD, GSA, industry and the private sector (generally expected to be from the accounting profession).

8-102.2 CAS Working Group **

a. To interpret the CASB rules and regulations for implementing in DoD procurement practices, DoD established in 1976 a CAS Steering Committee and Working Group. During its existence, the CAS Working Group issued a number of Interim Guidance Papers on a variety of subjects, most of which are still effective and have been incorporated into this chapter. The Interim Guidance Papers were approved by the Office of the Secretary of Defense (R&E) and given wide distribution.

b. The papers issued by the CAS Working Group that are still in effect are listed below. The full text of the papers can be found as a link in the DCAA Intranet under Headquarters Organization Information, Policy & Plans, Accounting and Cost Principles (PAC):

Table 8-1-1

No.	Subject
76-2	Administration of Cost Accounting Standards
76-3	Policy for Application of CAS to Subcontracts
76-4	Determining Increased Costs to the Government for CAS Covered FFP Contracts
76-5	Treatment of Implementation Costs Related to Changes in Cost Accounting Practices
76-6	Application of CAS Clause to Changes in Contractor's Established Practices when a Disclosure Statement has been Submitted

76-7	Significance of "Effective" and "Applicability" Dates Included in CAS
76-9	Measurement of Cost Impact on FFP Contracts
77-10	Retroactive Implementation of CAS When Timely Compliance is Not Feasible
77-13	Applicability of CAS 405 to Costs Determined to be Unallowable on the Basis of Allocability
77-15	Influence of CAS Regulations on Contract Terminations
77-16	Applicability of CAS to Letter Contracts
77-17	Identification of CAS Contract Universe at a Contractor's Plant
77-18	Implementation of CAS 414 - Cost of Money as an Element of the Cost of Facilities Capital; and DPC 76-3
77-19	Administration of Leased Facilities Under CAS 414
77-20	Policy for Withdrawing Adequacy Determination of Disclosure Statement
78-21	Implementation of CAS 410, Allocation of Business Unit G&A Expenses to Final Cost Objectives
78-22	CAS 409 and the Development of Asset Service Lives
79-23	Administration of Equitable Adjustments for Accounting Changes not Required by New Cost Accounting Standards
79-24	Allocation of Business Unit G&A Expense to Facilities Contracts
81-25	Change in Cost Accounting Practice for State Income and Franchise Taxes as a Result of Change in Method of Reporting Income from Long Term Contracts

8-102.3 Current Status of CAS - Recent Substantive CASB Promulgations **

a. On June 6, 1997, the CASB issued a final rule amending 9903.201-1(b)(6) to exempt from the requirements of CAS, firm-fixed-price and fixed-price with economic

price adjustments (provided that price adjustment is not based on actual costs incurred) contracts and subcontracts for the acquisition of commercial items. This exemption was effective July 29, 1996, with issuance of an interim rule. The exemption is a result of Section 4205 of the Federal Acquisition Reform Act of 1996 which amends 41 U.S.C 1502(b)(1)(C) (formerly 41 U.S.C. 422(f)(2)(B)). The final rule replaces the prior catalog and market price exemption at 48 CFR 9903.201 1(b)(6) and is applicable to all contracts and subcontracts awarded on or after July 29, 1996. The rule rescinds the CASB's December 18, 1995 Memorandum to Agency Senior Procurement Executives.

b. On June 9, 2000, the CASB issued a final rule affecting CAS applicability, thresholds and waiver of CAS coverage to implement provisions included in the National Defense Authorization Act for FY 2000. An interim rule had previously been issued effective April 2, 2000. The main features of the rule are:

- Increases the threshold for full CAS coverage and Disclosure Statements from $25 million to $50 million,
- Adds an exemption from CAS for contracts less than $7.5 million, provided the business unit is not currently performing any CAS-covered contracts valued at $7.5 million or more,
- Replaces the previous exemption at 48 CFR 9903.201-1(b)(15) (firm-fixed-price (FFP) contracts awarded without any cost data) with an exemption for FFP contracts awarded based on adequate price competition without certified cost or pricing data, and
- Delegates CAS waiver authority to heads of executive agencies under certain circumstances.

The FAR implemented the CAS changes on waiver authority in an interim rule effective June 6, 2000 (subsequently issued as a final rule without change). The waiver authority is discussed in 8-103.10.

c. On June 14, 2000, the CASB issued a final rule on Changes in Cost Accounting Practices. The CASB streamlined the final rule as a result of the expected decline in CAS-covered contracts resulting from the recent changes in applicability and thresholds and as a result of a proposed FAR rule on cost impact administration. The following summarizes the key aspects of the rule:

- Clarifies the applicable interest rate to use when recovering increased cost paid as a result of a noncompliance,
- Provides definitions of required, unilateral, and desirable changes to cost accounting practices,
- Expands existing guidance regarding "findings" determinations by the contracting officer,

- Clarifies the aggregate value of contract adjustments for unilateral changes and estimating noncompliances, and

- Includes an exemption from the cost impact process for cost accounting practice changes directly associated with external restructuring activities.

8-103 CAS Coverage Requirements and CAS Exemptions **

The following subsections contain a summary of CAS coverage requirements (see Figure 8-1-1).

8-103.1 Educational Institutions – CAS **

Contracts and subcontracts with educational institutions are subject to special CAS coverage (see CAM chapter 13). Contracts and subcontracts performed by federally funded research and development centers operated by educational institutions are subject to CAS coverage for commercial companies.

8-103.2 CAS Exemptions **

The following categories of contracts and subcontracts are exempt from all CAS requirements (48 CFR 9903.201-1):

a. Sealed bid contracts.

b. Negotiated contracts and subcontracts (including interdivisional work orders) less than the Truth in Negotiations Act (TINA) threshold.

c. Contracts and subcontracts with small businesses. FAR Subpart 19.3 addresses determination of status as a small business. A small business (offeror) is one which represents, through a written self-certification, that it is a small business concern in connection with a specific solicitation and has not been determined by the Small Business Administration (SBA) to be other than a small business. The contracting officer accepts an offeror's representation unless that representation is challenged or questioned. If the status is challenged, the SBA will evaluate the status of the concern and make a determination. (Specific standards appear in Part 121 of Title 13 of the Code of Federal Regulations.)

d. Contracts and subcontracts with foreign governments or their agents or instrumentalities or, insofar as the requirements of CAS other than CAS 401 and CAS 402 are concerned, any contract or subcontract awarded to a foreign concern.

e. Contracts and subcontracts in which the price is set by law or regulation.

f. Firm-fixed-price contracts and subcontracts for the acquisition of commercial items.

g. Contracts or subcontracts less than $7.5 million, provided that, at the time of award, the business unit of the contractor or subcontractor is not currently performing

any CAS-covered contracts or subcontracts valued at $7.5 million or greater. "Currently performing" is defined in 48 CFR 9903.301, Definitions. A contract is being currently performed if the contractor has not yet received notification of final acceptance of all supplies, services, and data deliverable under the contract (including options). "Currently performing" is intended to reflect the period of time when work is being performed on contractual effort. The period ends when the Government notifies the contractor of final acceptance of all items under the contract. If a contractor is currently performing a CAS-covered contract of $7.5 million or greater, CAS coverage is triggered and new awards are subject to CAS (unless they meet another exemption under 9903.201-1(b)).

h. Subcontracts under the NATO PHM Ship program to be performed outside the United States by a foreign concern.

i. Firm-fixed-price contracts and subcontracts awarded on the basis of adequate price competition without submission of certified cost or pricing data.

j. In cases where the prime contract is exempt from CAS under any of the exemptions at 9903.201-1 any subcontract under that prime is always exempt from CAS.

8-103.3 Types of Coverage **

a. Full coverage requires business units (as defined in CAS 410-30(a)(2)) comply with all of the CAS in effect on the contract award date and with any CAS that become applicable because of new standards (CAS clause at FAR 52.230-2). Full coverage applies to contractor business units that:

(1) Received a single CAS-covered contract award, including option amounts, of $50 million or more, or

(2) Received $50 million or more in CAS-covered contract awards during the immediately preceding cost accounting period.

The $50 million threshold became effective April 2, 2000. The previous $25 million threshold was effective from November 4, 1993 through April 1, 2000. Prior to November 4, 1993 the threshold was $10 million.

b. Modified CAS coverage (CAS clause at FAR 52.230-3) requires only that the contractor comply with CAS 401, 402, 405, and 406. Contracts with modified CAS coverage awarded prior to November 4, 1993 are subject to CAS 401 and 402 only. Modified CAS coverage applies to contractor business units that received less than $50 million in net CAS-covered awards in the immediately preceding cost accounting period.

c. When any one contract is awarded with modified CAS coverage, all CAS-covered contracts awarded to that business unit during that cost accounting period are also subject to modified coverage, except that when a business unit receives a single CAS-covered contract award of $50 million or more, that contract is subject to full

coverage. Thereafter, any covered contract awarded during that accounting period and the subsequent accounting period is subject to full CAS coverage.

d. The CAS status of a contract or subcontract (full coverage, modified coverage, or exempt from CAS), remains the same throughout its life regardless of changes in the business unit's CAS status in the current or subsequent cost accounting periods (i.e., a contract awarded with modified coverage remains subject to such coverage throughout its life even if subsequent period contracts are awarded with full coverage).

e. Subcontract coverage. (1) When a subcontract is awarded under a CAS-covered prime contract (and higher-tier subcontract), CAS coverage of the subcontract is determined in the same manner as prime contracts awarded to the subcontractor's business unit; i.e., determine if any of the exemptions from CAS at 48 CFR 9903.201-1 apply to the subcontract (see 8-103.2). (2) Working Group Paper 76-3, Policy for Application of CAS to Subcontracts, states that the standards applicable to the prime contract at the time it was awarded are also applicable to the subcontract. One might interpret this to mean that if a prime contract is subject to full CAS coverage, the subcontract is also subject to full CAS coverage. This appears to conflict with the guidance at 8-103.3e(1) that states that CAS coverage for subcontracts is determined in the same manner as it is determined for prime contracts awarded to the subcontractor's business unit. There is no conflict, however, because the Working Group Paper was issued before the category of modified coverage was created. When the Working Group Paper was issued, no distinction was made between full and modified coverage. As stated in 8-103.3e(1), CAS coverage at the subcontract level should continue to reflect the same CAS coverage as prime contracts awarded to the same business unit.

8-103.4 Effect of Contract Modifications **

Contract modifications made under the terms and conditions of the contract do not affect its status with respect to CAS applicability. Therefore, if CAS was applicable to the basic contract, it will apply to the modification. Conversely, if the basic contract was exempt from CAS, the modification will also be exempt regardless of the amount of the modification. However, if the contract modification adds new work it must be treated for CAS purposes as if it were a new contract. In this case, if the modification exceeds the threshold, it will be CAS-covered (see CAS Working Group Paper 76-2).

8-103.5 Effect of Basic Ordering Agreements **

Basic agreements and basic ordering agreements (BOAs) are not considered contracts (FAR 16.702(a) and 16-703(a)). Since orders must be considered individually in determining CAS applicability, only orders that exceed the threshold will be CAS-covered (see CAS Working Group Paper 76-2).

8-103.6 Effect of Letter Contracts **

CAS is applicable to letter contracts exceeding the threshold as of the date of the award. Definitizing the contract will not activate any new standards since definitization is a contract modification rather than a new contract (see CAS Working Group Paper 77-16).

8-103.7 CAS Flowdown Clause - FAR 52.230-2 **

The CAS clauses at FAR 52.230-2(d) and FAR 52.230-3(d) (for full and modified coverage, respectively) require a contractor to include the substance of the CAS clause in all negotiated subcontracts (at any tier) into which the contractor enters. This is commonly referred to as the "CAS flow down clause". As discussed in 8-103.3e however, if a subcontract meets one of the CAS exemptions at 48 CFR 9903.201-1 (see 8-103.2), the subcontract will not be subject to CAS. For example, a CAS-covered prime contractor could not place the requirement for CAS compliance on a subcontract with a small business because 9903.201-1(b)(3) specifically exempts contracts and subcontracts with small businesses from CAS requirements.

8-103.8 Submission of Disclosure Statement **

The requirements for submission of a Disclosure Statement (9903.202-1(b)) are:

a. Any business unit (as defined in CAS 410-30(a)(2)) that is selected to receive a CAS-covered contract or subcontract of $50 million or more, including option amounts, shall submit a Disclosure Statement before award.

b. Any company which, together with its segments (see CAS 410-30(a)(7)), received net CAS-covered awards totaling more than $50 million in its most recent cost accounting period shall submit a Disclosure Statement. When a Disclosure Statement is required under these criteria, it must be submitted before award of the first CAS-covered contract in the immediately following cost accounting period. However, if the first covered award is made within 90 days of the start of the cost accounting period, the contractor is not required to file until the end of the 90 days.

c. When required, a separate Disclosure Statement must be submitted for each segment having more than the Truth in Negotiations Act (TINA) threshold of costs included in the total price of any CAS-covered contract or subcontract, unless:

(1) The contract or subcontract is exempted by 48 CFR 9903.201-1, or

(2) In the most recently completed accounting period, the segment's CAS-covered awards are less than 30 percent of total segment sales for the period and less than $10 million.

d. Any home office (as defined in CAS 403-30(a)(2)) that allocates costs to one or more disclosing segments performing CAS-covered contracts must submit a part VIII of the Disclosure Statement.

8-103.9 Additional Exemptions on a Particular Standard **

Subsection 62 of each cost accounting standard will provide for any additional exemptions associated with a particular standard.

8-103.10 CAS Waivers **

a. The CAS statute (Public Law 100-679) authorizes the CAS Board to waive

CAS requirements on individual contracts and subcontracts. CAS 9903.201-5 addresses CAS waivers.

b. Effective April 2, 2000, the CAS Board granted authority to waive CAS to heads of executive agencies. Implementing guidance is in FAR 30.201-5 and DFARS 230.201-5. FAR 2.101 defines "executive agency" as executive, military, and independent departments. Delegation of waiver authority may not be made lower than the senior contract policymaking level of the agency.

c. Heads of executive agencies may waive CAS under the following two circumstances:

- The contract or subcontract is less than $15 million, and the segment performing the work is primarily engaged in the sale of commercial items and has no contracts or subcontracts subject to CAS, or

- "Exceptional circumstances" exist whereby a waiver of CAS is necessary to meet the needs of the agency. Exceptional circumstances are deemed to exist only when the benefits to be derived from waiving CAS outweigh the risk associated with the waiver. A waiver for exceptional circumstances must be in writing and include a statement of the specific circumstances that justify granting the waiver. The Defense Procurement and Acquisition Policy on January 31, 2003 issued guidance, which provides that all three of the following criteria must be met for a waiver of CAS to be considered under "exceptional circumstances" for DOD contracts.

(1) The property or services cannot reasonably be obtained under the contract, subcontract, or modification, as the case may be, without the grant of the waiver,

(2) The price can be determined to be fair and reasonable without the application of the Cost Accounting Standards, and

(3) There are demonstrated benefits to granting the waiver.

8-104 CAS Audit Responsibility **

8-104.1 Basic Functions **

FAR 30.202-6, 30.202-7, and 30.601 outline the basic functions of the contract auditor in the implementation of the standards. They provide that the contract auditor shall be responsible for making recommendations to the cognizant Federal agency official (CFAO). The CFAO is the contracting officer assigned by the cognizant Federal agency to administer CAS. Within DoD, the CFAO is the cognizant ACO. The auditor's recommendations to the CFAO include whether:

- a contractor's Disclosure Statement, submitted as a condition of

contracting, adequately describes the actual or proposed cost accounting practices as required by 41 U.S.C. 1501 through 1506 as implemented by the CASB,

- a contractor's disclosed cost accounting practices are in compliance with FAR Part 31 and applicable cost accounting standards,

- a contractor's or subcontractor's failure to comply with applicable cost accounting standards or to follow consistently its disclosed or established cost accounting practices has resulted, or may result, in any increased cost paid by the Government, and

- a contractor's or subcontractor's proposed price changes, submitted as a result of changes made to previously disclosed or established cost accounting practices, are fair and reasonable.

8-104.2 Auditor's Function on Subcontracts Subject to CAS **

As specifically related to subcontracts subject to CAS, the auditor's functions tend to fall into the following areas:

a. The auditor will audit the books and records of prime contractors and higher tier subcontractors to determine that appropriate CAS clauses are included (FAR 52.230-2, 52.230-3, and 52.230-6) in awarded subcontracts. In addition, the auditor will determine that, when applicable, subcontractor Disclosure Statements have been obtained.

b. 48 CFR 9903.202-8(a) and FAR 42.202(e)(2) provide that the company awarding the CAS-covered subcontract is responsible, except as noted in c. and d. below, for securing subcontractor compliance with CASB rules, regulations, and standards. Notwithstanding these provisions, in most cases compliance audits of CAS-covered subcontracts will be performed by the auditor cognizant of the subcontractor in conjunction with the performance of other regularly scheduled audit assignments. When DCAA audits a prime contractor that also holds covered subcontracts, the auditor should routinely include the subcontracts in the CAS-covered audits. Even though the audit responsibility may not have been formally assigned, the auditor, to protect the Government's interest, must consider all covered work held by the contractor when making CAS-related audits. At locations where no Government prime contracts exist, the auditor should attempt to identify the existence of CAS-covered subcontracts either during the performance of regular ongoing audits or through routine examinations of existing acquisition records. Once identified, these subcontracts will also be subject to audit tests for CAS compliance.

c. Under the provisions of 48 CFR 9903.202-8(b) a subcontractor may satisfy disclosure requirements by identifying to the prime contractor the CFAO to whom its Disclosure Statement was previously submitted. 48 CFR 9903.202-8(c)(1) provides that the subcontractor may submit a Disclosure Statement that contains privileged and confidential information directly to the subcontractor's CFAO. In this case, a preaward

determination of adequacy is not required. Instead, the CFAO will advise the auditor to perform postaward audits of compliance.

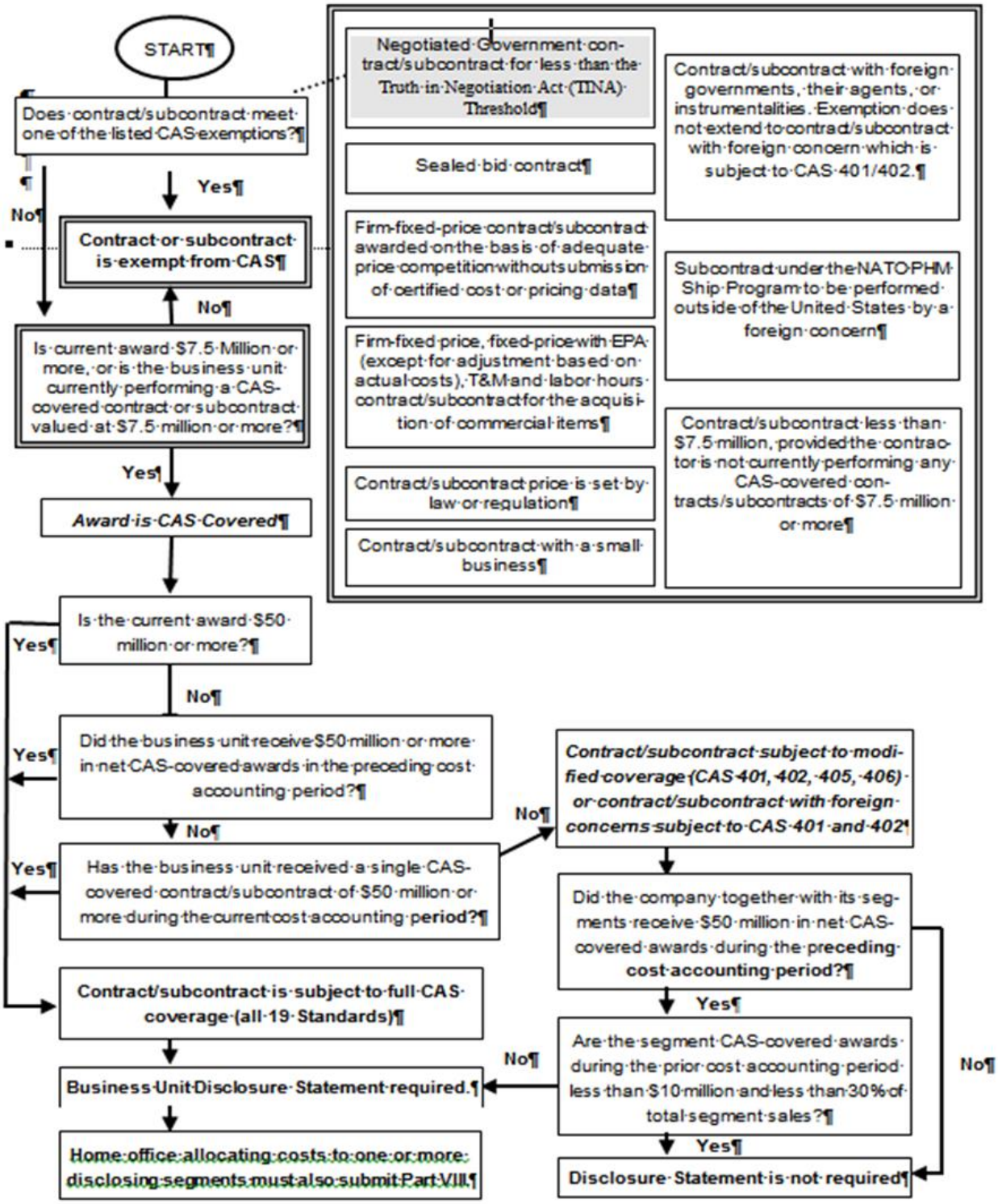
d. In accordance with 48 CFR 9903.202-8(c)(2), subcontractors not subject to Disclosure Statement requirements may claim that other CAS-related audits by prime contractors would jeopardize their proprietary data or competitive position. In such cases, the subcontractor may request the Government to perform the audits.

8-104.3 Contract Audit Coordinator (CAC) **

The CAC will be responsible for assuring, for all organizational units of the assigned company, that consistent and compatible audit conclusions are reached by all FAOs involved. Specific responsibilities for all auditors in the coordination process are in subsequent sections of this chapter. If a CAC has not been assigned to a multidivisional contractor, the regional director cognizant of the corporate home office will designate a Corporate Home Office Auditor (CHOA) or Group Audit Coordinator (GAC), as applicable (see also 8-204 for audit coordination within multiorganizational companies).

Figure 8-1-1 - CAS Coverage and Disclosure Statement Determination

CAS Exemptions – 48 CFR 9903.201-1(b)



8-200 Section 2 - Disclosure Statement Adequacy **

8-201 Introduction to Audits of Disclosure Statement **

See MRD 14-PAC-010(R) for guidance in determining adequacy of a disclosure statement.

8-300 Section 3 - Audits of Compliance with Cost Accounting Standards Board (CASB) Rules, Regulations, and Standards, and with FAR **

8-301 Introduction **

a. This section provides audit guidance for the evaluation of the contractor's Disclosure Statement and the practices used for estimating, accumulating and reporting costs on contracts subject to 41 U.S.C. 1501 through 1506. The purpose of the audit is to ascertain whether the disclosed or established practices are in compliance with the CASB rules, regulations, and standards as well as appropriate acquisition regulations. The initial audit of a Disclosure Statement's compliance should be scheduled for completion within 60 days after the CFAO's determination of adequacy of the Disclosure Statement. The aspects of compliance audits covered in this section are:

(1) General requirements including audit considerations and reporting procedures.

(2) Audit considerations involved in the initial audit of the Disclosure Statement for compliance.

(3) Audit requirements associated with the audit of cost accounting practices for compliance during the proposal evaluation and contract performance.

b. Not only should the audit and subsequent reporting cover those conditions that constitute actual noncompliances but should also include circumstances where the occurrence of a planned or pending action will result in a violation of CASB rules, regulations, or standards. A condition of potential noncompliance exists when:

(1) a contractor with a covered contract proposes a practice that will violate a cost accounting standard or FAR cost principle when implemented (see 8-302.7f), or

(2) a contractor who does not have a covered contract but currently has or proposes to implement a practice that, with the award of the initial covered contract, will result in a violation of the CASB rules, regulations, and standards or appropriate acquisition regulations. It is important to note that in each of the potential noncompliance conditions described above, some future action is required before the contractor is in violation of 41 U.S.C. 1501 through 1506. For example, the offeror must be awarded a CAS-covered contract before it becomes subject to the rules and regulations of the CASB. Similarly, a covered contractor must implement an

unacceptable practice to be in actual noncompliance.

c. To facilitate the implementation process, each promulgated standard contains subparagraph .63 that prescribes the effective date and an applicability date. The CASB defers the applicability date beyond the effective date in order to provide contractors adequate time to prepare for compliance and make any required accounting changes. Under the regulation, a contractor becomes subject to a new standard only after receiving the first CAS-covered contract following the effective date.

(1) The distinction between the effective and applicability dates is important. The effective date designates when the pricing of future CAS-covered contracts must reflect the new standard. It also identifies those CAS-covered contracts eligible for an equitable adjustment, since only contracts in existence on the effective date can be equitably adjusted to reflect the prospective application of a new or revised standard.

(2) The applicability date marks the beginning of the period when the contractor's accounting and reporting systems must comply with a new or revised standard. Proposals for contracts to be awarded after the effective date of a standard should be evaluated carefully for compliance with the new or revised standard. The proposal need only reflect compliance with the standard from the applicability date forward. Therefore, it is important that the auditor determine the applicability date of the particular Standard (including any revisions) under audit. Any change resulting from early implementation by the contractor is to be administered as a unilateral change. It will result in an equitable adjustment under FAR 52.230-2(a)(4)(iii) for the period prior to the applicability if the CFAO determines that the unilateral change is a desirable change.

(3) In unusual situations, the short lead-time between the effective and applicability dates may create a difficult situation for the contractor. In such a case, the contractor may request the change be retroactive. The CFAO shall determine whether the contractor’s request is approved or not; however, the CFAO cannot approve a date for the retroactive change before the beginning of the year in which the request was made. Where a contractor can demonstrate to the CFAO that it would be virtually impossible to comply with the effective or applicability dates of a standard, contracts can be negotiated after the effective date of the standard based on the accounting system used before the standard became effective.

(4) Contract terms should include provisions for price adjustments, retroactive to the applicability date, for significant cost impact resulting from the change in accounting practice to comply with the standard. In addition, the CFAO should establish a specific date for the contractor to complete the changes to its estimating, accounting, and reporting systems and Disclosure Statement to comply with the standard. When this procedure is followed, noncompliances will not be reported. Equitable adjustments computed as of the applicability date will be submitted as provided in FAR 30.604(h)(4). (See CAS Working Group Papers 76-7 and 77-10.)

d. Questions have been raised regarding the CAS compliance of termination claims since:

(1) costs in termination claims may be arranged differently than the cost presentations in the original estimates, and

(2) termination claims often include as direct costs such items as settlement costs or unexpired leases that would have been charged indirect if the contract had been completed. Termination costing procedures, as detailed in FAR 31.205-42, are still effective. DoD does not view these procedures as violating either CAS 401 or 402, since terminating a contract creates a situation that is totally unlike completing a contract. Therefore, these costs would not be considered costs incurred for the same purpose in like circumstances. Termination contracting officers should assure themselves that within the context of termination situations, consistency is honored to the extent that the circumstances are similar. To that end, it would be advisable for a contractor to document its termination accounting procedures as part of its disclosed practices. Indirect cost rates used in termination claims must represent full accounting periods as required by CAS 406. (See CAS Working Group Paper 77-15.)

8-302 Noncompliance with CAS **

8-302.1 Requirements **

a. In accordance with FAR 30.605(b) when the CFAO determines a disclosed or an established practice is not in compliance, the CFAO shall notify the contractor and provide a copy of the notice to the auditor. The CFAO also makes a determination of materiality.

(1) If the CFAO determines that the noncompliance is immaterial, the contractor must correct the noncompliance and the Government reserves the right to make contract adjustments if the contractor fails to correct the noncompliance and it becomes material.

(2) If the CFAO determines that the noncompliance is material, the contractor is required to submit a description of any accounting practice change needed to bring the practices into compliance, which the auditor will review for adequacy and compliance. If the proposed change is both adequate and compliant, the contractor must submit a general dollar magnitude (GDM) proposal. In addition, adjustment of the prime contract price or cost allowance in accordance with FAR 30.605 may be required. (See 8-500)

b. As in FAR 30.202-6 and 30.202-7, the contract auditor shall be responsible for conducting audits as necessary to advise the CFAO as to whether the contractor's disclosed or established practices comply with CAS and FAR Part 31. Because the audit responsibility is a continuous requirement, instances of noncompliance may be detected and reported at various stages of the procurement action.

8-302.2 Types of Noncompliance **

a. Eight types of noncompliance can be identified based on CASB rules, regulations, and standards and FAR Part 31:

(1) Disclosed practices not compliant with CAS.

(2) Disclosed practices not compliant with FAR.

(3) Actual practices of estimating costs not compliant with CAS.

(4) Actual practices of estimating costs not compliant with FAR.

(5) Actual practices for estimating costs not compliant with the practices disclosed in the Disclosure Statement.

(6) Actual practices for accumulating or reporting costs not compliant with CAS rules and regulations.

(7) Actual practices for accumulating or reporting costs not compliant with FAR.

(8) Actual practices for accumulating or reporting costs not compliant with the practices disclosed in the Disclosure Statement.

b. The first two types of noncompliance situations may be detected during the initial Disclosure Statement audit or during normal audits, such as price proposal evaluations, or during audits of incurred cost, as discussed in 8-304. Situations related to bullets three through five above would likely be detected during a proposal evaluation or an estimating system survey. Situations six through eight would generally be detected during normal or routine audits of actual costs.

c. In some cases multiple noncompliance conditions may exist. For example, a contractor normally allocates the costs of preparing initial bid proposals to cost objectives on the basis of total cost input. This practice, which conforms with FAR 31.205-18 and CAS 420, was previously disclosed to the Government. For a new proposal, however, the associated B&P expenses were charged to the engineering overhead which was subsequently allocated to the resulting contract on the basis of direct engineering labor dollars. Under these conditions, the types of noncompliances described in bullets (6), (7), and (8) above would all apply.

d. A new cost accounting standard could also result in instances of multiple types of noncompliance. For example, with the issuance of a new standard, a disclosed practice previously considered to be compliant could be rendered unacceptable in the following areas:

(1) described practices could be in noncompliant with CAS or FAR, and

(2) practices used to record costs, although in conformance with the Disclosure Statement, could be noncompliant with CAS and/or FAR.

8-302.3 Compliance Considerations **

In auditing the contractor's cost accounting practices to ascertain whether they

are compliant with the cost accounting standards and FAR Part 31, the auditor should follow the guidelines below:

a. In evaluating price proposals and performing estimating system surveys, the auditor is required to describe inconsistencies between the contractor's estimating and cost accumulating practices. The auditor may therefore be in a position, based on past audits, to ascertain whether the contractor complies with the standard requiring consistency in estimating, accumulating, and reporting costs.

b. The standard prohibiting double counting (CAS 402) did not introduce an entirely new ground rule since acquisition regulations contained similar provisions. The prohibition against double counting in the acquisition regulations however, was narrower in scope since it basically applied to individual contracts. CAS 402 has extended the scope by adding the requirement that each type of cost incurred for the same purpose, in like circumstances, must be either direct or indirect for all final cost objectives. Prior audits of the contractor's incurred costs may provide information on whether the cost accounting practices comply with this standard.

c. With respect to noncompliance with FAR Part 31, when a cost accounting practice has been questioned by the auditor in the past and the CFAO has not made a final determination, the practice should be questioned again. Once the CFAO makes a determination on the issue, the decisions will be followed. If the FAR is subsequently changed or a change in circumstance occurs, a practice should again be evaluated for compliance.

d. If a cost accounting practice has been questioned because of noncompliance with FAR Part 31 and the CFAO supported the auditor's position, but the ASBCA or Court of Claims ruled against the Government, the auditor will not question the practice again unless there is a subsequent change in FAR or the cost accounting standards that would negate the decision. However, if the ASBCA or the Court of Claims ruled in favor of the Government, the practice should be questioned at all other contractor locations where circumstances are substantially the same.

8-302.4 Discussions with the CFAO and the Contractor **

a. The auditor should discuss noncompliance matters with the CFAO at the earliest possible opportunity. It is important to keep the CFAO informed of the auditor's actions and to identify areas where the auditor may need to provide further information regarding his or her recommendations.

b. As an integral part of the audit, discuss the findings with the contractor. (See 4-300.)

8-302.5 Coordination for Consistent Treatment **

a. Because of the consolidated contract audit function and the relationship of the CASB rules, regulations, and standards to the DCAA mission, DCAA is in an advantageous position to ascertain whether the promulgated standards, rules, and regulations are consistently applied. To fulfill this responsibility, DCAA must effectively

coordinate all phases of audits involving CAS.

b. Consistency in implementing CASB rules, regulations, and standards should be one of the auditor's primary concerns. Contractors are justifiably sensitive to unwarranted variations in the audit treatment of similar situations. To assure the provisions of 41 U.S.C. 1501 through 1506 are applied consistently, audit findings that are significant in amount or nature should ordinarily be coordinated with the region and CAC before the reports are issued.

c. When coordination involves other DCAA regional offices, the cognizant auditor should refer to his or her region those matters that cannot be resolved by the FAOs involved. The region may forward the matter to Headquarters, Attention PAC, if agreement is not achievable at the regional level. (See 4-900.)

d. Information on other significant problems or controversial situations will also be provided to Headquarters, Attention PAC. (See 4-900.) This information will assist in developing guidance to improve auditing and reporting techniques or in referring matters to the Office of the Secretary of Defense (OSD) when DoD-wide guidance is needed to achieve uniform and consistent implementation of CAS.

8-302.6 CAS Coordination in CAC/CHOA/GAC Complexes **

a. The DCAA CAC program, for major multi-segment contractors and other specific groups of contractors, is described in 15-200. The CHOA or GAC will be designated in accordance with 8-104.3 for multi-segment contractors outside a CAC complex. The CAC, CHOA, and GAC complexes play a significant part in promoting consistent treatment of CAS compliance issues among related or similar contractor segments.

b. Each CAC/CHOA/GAC will:

(1) Obtain from the cognizant FAOs the necessary data to compile a listing of all known noncompliance issues at each of the segments that comprise the complex. The listing, along with information on resolution of the issues, should be distributed to all FAOs that have cognizance of any segment within the complex.

(2) Review and update the listing for new instances of noncompliance and include information regarding noncompliance issues resolved. Circulate this data to the cognizant FAOs to keep them informed about current developments.

(3) Before issuing a noncompliance report, discuss the recommendations with the FAO. This should be done to assure consistent treatment of similar conditions at the various segments of the complex.

(4) Recommend workshops if needed to evaluate mutual CAS problems, (see 15-200).

c. FAOs in the complex will:

(1) Inform the CAC/CHOA/GAC of known problem areas.

(2) Inform the CAC/CHOA/GAC immediately when new problem areas are encountered.

(3) Evaluate problem areas of other organizational units to determine if similar problems exist or could exist at your location.

(4) Plan audits so findings can be coordinated before reports are issued.

8-302.7 Reporting CAS Noncompliance **

a. In assigning responsibilities to the CFAO and the contract auditor, the regulations (FAR 42.302(a)(11)), FAR 30.601, and FAR 30.202-6), require the auditor to conduct audits of Disclosure Statements for compliance and report practices that do not comply with CASB rules, regulations, and standards. The CFAO is to determine whether the reported practices actually do not comply with the CAS Rules and Regulations or FAR Part 31. Noncompliance reports should include only CAS violations that the auditor considers significant. The auditor should report:

(1) Violations of major requirements of CAS regardless of their effect on contract costs.

(2) Noncompliance having a significant cost effect on CAS-covered contracts.

(3) Noncompliance that could eventually result in a significant adjustment because of changed circumstances even though there is currently no significant effect on contract costs. Note that a noncompliance report will not be issued when the auditor determines the noncompliance will never result in a significant adjustment.

(4) Noncompliance that is an inherent part of the contractor's cost accounting system and that are of such a nature that the cost impact on CAS-covered contracts would be difficult or impossible to determine. (In ASBCA Case No. 20998, the Board upheld the Government's right to determine a contractor to be in noncompliance even though the Government was unable to determine that increased costs resulted from the noncompliance. This ASBCA decision should be referenced in all audit reports recommending noncompliance where the cost impact cannot be determined.)

b. The following are examples of practices that deviate from CAS. Even if such practices have not resulted in increased cost or no increased cost can be determined, the conditions described are reportable as noncompliances.

(1) A contractor allocates home office expenses to divisions as fixed management charges. The charges are less than the amounts that would have been allocated had the contractor followed CAS 403. The auditor should recommend that the CFAO advise the contractor that costs will be disapproved when the method used by the contractor results in an amount exceeding that which would have been allocated under the standard.

(2) Another contractor estimates labor cost by category, i.e., fabrication assembly, inspection, etc. The actual costs are accumulated in one undifferentiated account. Under these circumstances, the auditor would not be able to determine if there is any cost effect since there are no records to compare. The auditor should report the noncompliance and recommend that the contractor be required to follow consistent practices in estimating and accumulating labor costs.

c. The following guidance should be followed in reporting instances of noncompliance with CAS.

(1) The auditor may discover instances of noncompliance while performing any of his or her other audit functions, i.e., price evaluations, audit of incurred costs, Disclosure Statement CAS compliance audits, and system audits. Regardless of the circumstances under which noncompliance are found the auditor will include noncompliance issues in a separate report (activity code 19200). To avoid unnecessary and duplicative reporting, the CAS noncompliance will be fully described in the noncompliance report and other reports may cross-reference that report.

(2) Generally, when the audit discloses noncompliances with more than one cost accounting standard, a separate noncompliance audit report should be issued for each standard. However, noncompliances with two or more standards should be issued in the same report when the noncompliances are related or inseparable. Noncompliances are related or inseparable if the resolution of one resolves the other. Usually, auditors should not issue multiple audit reports for noncompliances with a single CAS.

(3) Reports will be issued as the auditor discovers instances of noncompliance during normal audit functions. There is no requirement for final voucher evaluation memorandums and audit reports on final pricing to include a "clearance" statement with respect to compliance with 41 U.S.C. 1501 through 1506.

d. The auditor is responsible for conducting audits as necessary to ascertain that contractors are complying with CAS. Therefore, a general request by a CFAO for reports and/or comments on contractor compliance is not needed. If such a request is received, inform the CFAO that although DCAA does perform compliance audits of specific Cost Accounting Standards, we do not issue reports on contractor overall compliance with CAS. (See 8-304.2 regarding scheduled annual compliance audits.) Offer to audit and report on any specific area that the CFAO may suspect is noncompliant. If a CAS compliance audit is already planned in the area of concern specified by the CFAO, the audit should be rescheduled to coincide with the CFAO request. When an audit relating to a particular identified practice is requested, the auditor and the CFAO will establish a mutually acceptable date for submitting the audit results. The auditor will then include the required audit steps to cover the questioned practice in the next scheduled audit or, if necessary, will schedule a special audit. The CFAO's request to audit a specific practice should be given prompt consideration, but should not receive higher priority than proposal evaluations. Acknowledge the audit request or notify the CFAO of the planned audit in accordance with 4-104. After the

audit, issue either a report on noncompliance or a brief report to inform the CFAO that the audit disclosed no noncompliance in the specific area cited by the CFAO.

e. Reports on noncompliance will be prepared and distributed per 10-808.

f. Outstanding noncompliance issues (issues included in a previous noncompliance report) may affect evaluations and reports related to other audits. If a noncompliance report has been issued, the evaluation of a price proposal must comment on and should question the impact of the noncompliance item on the proposal being evaluated. If a CAS noncompliance is found during a proposal evaluation or other audit, the report for that audit can be issued prior to the issuance of the CAS noncompliance report. However, a CAS noncompliance report is still required so that the CFAO can take action.

8-302.8 Reporting FAR Noncompliance **

A noncompliance that violates both FAR and similar provisions in CAS should be reported in one report and processed as required under FAR 52.230-2(a)(5) to correct the noncompliance and recover any cost impact due the Government (see 8-302.7 above). A noncompliance with FAR that does not violate CAS (or the contractor has no CAS-covered contracts) is normally reported and the impact recovered as part of other audits (e.g., incurred cost, forward pricing).

8-303 Audit of Disclosure Statement and/or Established Practices to Ascertain Compliance with CAS and FAR **

8-303.1 Requirements **

a. FAR 52.230-2 (full CAS coverage) requires the contractor to adequately disclose its cost accounting practices for all covered contracts. FAR 52.230-3 (modified CAS coverage) also requires a contractor to adequately disclose its cost accounting practices under certain circumstances (see 8-103.8.c). An audit of the initial Disclosure Statement will be made to ascertain compliance with Public Law 100-679 (41 U.S.C. 1501 through 1506).

b. A noncompliance disclosed during an evaluation of a price proposal should be included in a separate report and submitted to the CFAO with the evaluation report.

c. Audit files may contain sufficient information to determine whether the Disclosure Statement complies with 41 U.S.C. 1501 through 1506, related regulatory provisions, and FAR. The auditor should identify all significant areas where the contractor's disclosed practices are not in compliance. Audit working papers should sufficiently document the auditor's opinion regarding whether the contractor’s disclosed practices comply with CAS and FAR.

d. FAR 30.202-7(b) provides that the contractor’s cost accounting practices should comply with FAR Part 31 as well as CAS. However, the auditor should report as noncompliances only those FAR violations that involve the direct and indirect allocation or classification of costs. Essentially, this limitation excludes reporting as

noncompliance those FAR violations based solely on reasonableness or allowability.

8-303.2 Initial Audits of Compliance **

a. An initial compliance audit of a contractor's Disclosure Statement, as a rule, should be scheduled for completion within 60 days after the CFAO has made a determination of adequacy of the Disclosure Statement. Notify the CFAO of the audit in accordance with 4-104. To avoid unnecessary effort at contractors having limited Government business, the auditor should find out whether a covered contract has been awarded before engaging in extensive audit effort to ascertain compliance.

b. The scope of compliance audits of initial Disclosure Statements should be limited to determining whether the described practices comply with CAS and FAR Part 31. The auditor should not conduct transaction testing to determine if the contractor's actual practices comply with the described practices. Testing of actual compliance will be tested later in accordance with the routine audit planning cycle. However, the auditor may be aware through other audit work that an actual practice is noncompliant with the disclosed practice. In this case, the auditor will report the noncompliance in accordance with 10-808.

c. Upon completion of the compliance audit of the initial Disclosure Statement, the auditor should issue an audit report in accordance with 10-805.

8-303.3 Changes to Disclosure Statements and/or Established Practices **

a. In accordance with FAR 52.230-6, the contractor must submit proposed accounting changes to the CFAO. The timeframes for submission of proposed changes are provided in FAR 52.230-6(b). 48 CFR 9903.302 provides definitions of "cost accounting practice", "change to a cost accounting practice" and contains illustrations of changes. CAS Working Group Paper 81-25 concluded that a change from a percentage of completion to a completed contract method of computing state taxes was an accounting change. A change in accounting from a completed contract to a percentage of completion, or a percentage of completion capitalized cost method as required by the Tax Reform Act of 1986 is considered an accounting change.

b. An important CAS audit responsibility is to ascertain whether accounting changes made by a contractor require a revision to the Disclosure Statement. Therefore, auditors should request contractors to establish procedures to promptly notify the Government of all proposed accounting changes. The auditor will evaluate the acceptability of the contractor's proposed accounting changes. When a Disclosure Statement revision is required but is not made, a noncompliance report should be issued (e.g., practices used to record costs are not in compliance with Disclosure Statement). A condition of noncompliance could also result from the contractor's failure to follow the administrative procedures prescribed by FAR 52.230-6 in making an accounting change. When the CFAO determines that the description of the change is adequate and compliant and that the cost impact is material, the CFAO will request submission of a cost impact proposal in accordance with FAR 30.604.

c. A condition of noncompliance exists if, for example, a contractor estimates a contract using a cost accounting practice consistent with its Disclosure Statement, and at some point during the performance, changes the methods for computing and accumulating a labor class, whether or not it was listed as a principal class of labor in the Disclosure Statement. Costs are being accumulated in a manner inconsistent with estimating practices and not in accordance with the Disclosure Statement. The report to the CFAO should recommend that:

(1) a determination of noncompliance (CAS 401) be made,

(2) a general dollar magnitude submission be requested from the contractor to evaluate the effect of the changed practice, and

(3) a revised Disclosure Statement be requested from the contractor describing all principal classes of labor.

d. Preamble J of the CASB's rules, regulations, and standards (see the FAR Appendix AP-2) contains a discussion by the CASB on organizational changes. The preamble states in part that, "... business changes by themselves are not changes in cost accounting practices". However, it also states that, "The decision as to whether there is a change in cost accounting practice is made through an analysis of the circumstances of each individual situation being promulgated in these regulations".

Organizational changes that result in a change in the measurement of costs, the assignment of costs to cost accounting periods, or the allocation of costs to cost objectives, should be considered to be changes in cost accounting practice requiring an adjustment to CAS-covered contracts for any increased costs. As a result of U.S. Court of Appeals for the Federal Circuit No. 93-1164, a corporate reorganization that involves a change in the grouping of segments for home office expense allocation purposes should not be considered a change in accounting practice unless the method or technique used to allocate the costs changes. For all other circumstances, auditors need to evaluate the specifics of each situation on a case-by-case basis to determine whether a change in accounting practice has resulted from a change in the measurement, allocation, and assignment of costs.

e. When a Disclosure Statement change is submitted, the auditor should ascertain its adequacy and compliance before the effective date. The timeframe for completing these audits should be coordinated with the CFAO (see 4-104). The auditor will issue a report on compliance. (See 14-PAC-010(R) and 10-806.)

8-304 Audit of Estimated, Accumulated, and Reported Costs to Ascertain Compliance with CAS and FAR **

8-304.1 Requirements **

a. The cognizant contract auditor is responsible for conducting audits to ascertain whether a contractor's actual cost accounting practices comply with CAS and FAR Part 31. Compliance with CAS is required for all contractors that have contracts containing

the CAS clause without regard to whether a Disclosure Statement has been submitted.

b. FAR Part 31 has made some of the CAS requirements applicable to contracts that do not contain the CAS clause. Therefore the auditor is responsible for assuring compliance with these FAR provisions as well; however, non-compliance with FAR Part 31 shall be reported separately from CAS non-compliances.

8-304.2 Compliance Audits **

a. Testing for compliance with FAR Part 31 and CAS is an inherent part of every contract audit. Auditors are expected to be knowledgeable of compliance requirements and consider them as applicable in examination of contract proposals and incurred cost. In addition a comprehensive audit of a contractor's compliance with each applicable cost accounting standard, except for CAS 401, 402, 405 and 406, shall be conducted once every three years, unless circumstances at the contractor warrant conducting the audit sooner. The comprehensive compliance audits will cover the incurred cost in the last completed contractor fiscal year and serve to provide added assurance to the overall consideration of all applicable CAS requirements in audit work performed during the intervening years.

b. During annual audit planning (see Chapter 3 and the Planning section of the DMIS User Guide), identify those standards for which tests of CAS compliance are necessary. Establish separate audit assignments for each standard to be tested. The auditor's assessment of risk for each standard should identify those provisions of a standard that are significant to the particular contractor. Auditors must consider the materiality criteria provided in 48 CFR 9903.305 in developing the nature and extent of CAS compliance tests.

c. The initial Disclosure Statement compliance audit for a new standard should be scheduled as soon as possible after the effective date of the new standard. (See MRD 14-PAC-010(R) for determining adequacy of disclosure statements.) The timeliness of the audit is especially important for those practices that may involve significant costs. If the audit is performed soon after a new standard's effective date, the auditor will have a basis for determining whether the accounting practices reflected in pricing proposals comply with the new standard.

8-304.3 Reporting of Compliance Audit Results **

a. An audit report should be issued whether the audit disclosed instances of noncompliance or not. The audit report should inform the CFAO of the specific area being audited even if the audit disclosed no instances of noncompliance. If noncompliance is disclosed, the audit report should explain in detail the issues involved.

b. The auditor may detect noncompliance at any stage of a procurement action. Noncompliance should be reported whenever detected. Special care is necessary to ensure that proposal evaluation reports that reveal instances of noncompliance are accompanied by a noncompliance report.

8-400 Section 4 - Cost Accounting Standards **

This section contains guidance to evaluate compliance with specific cost accounting standards (CAS). Additional illustrations are included in an attempt to provide auditors with a common understanding of the standards. This section will be amended to include specific audit guidance for the standards promulgated in the future. The cost accounting standards (48 CFR Chapter 99) and the CAS Preambles are included as FAR Appendix AP-2 on the Hill Air Force website.

8-401 Cost Accounting Standard 401 - Consistency in Estimating, Accumulating and Reporting Costs **

a. The purposes of this standard are to:

(1) achieve consistency in the cost accounting practices used by a contractor in estimating costs for its proposals with those practices used in accumulating and reporting costs during contract performance, and

(2) provide a basis for comparing such costs. The standard was effective and applicable to all CAS-covered contracts awarded after July 1, 1972.

b. Cost accounting practices should be applied consistently so that comparable transactions are treated alike. The consistent application of cost accounting practices facilitate the preparation of reliable cost estimates used in pricing a proposal and the comparison of those cost estimates with the actual costs of contract performance. Such comparisons of estimated and incurred costs provide for:

(1) an important basis for financial control over costs during contract performance,

(2) a means for establishing accountability for costs in the manner agreed-to by both parties at the time of contracting, and

(3) an improved basis for evaluating estimating capabilities.

8-401.1 Consistency between Estimating and Accumulating Costs **

a. The consistency requirement between estimating and accumulating costs is a two-part requirement. First, the contractor's practices used to estimate costs in pricing proposals must be consistent with practices used in accumulating actual costs. Second, the contractor's practices used in accumulating costs must be consistent with practices used to estimate costs in pricing the related proposal. Thus, noncompliance with the standard can exist because a contractor has failed to estimate its cost in accordance with its established or disclosed accounting practices; noncompliance can also occur when a contractor estimates in accordance with its disclosed or established practices but accumulates on a different basis without obtaining the prior agreement of the Government.

b. One of the primary problems involved in the implementation of this standard relates to the consistency in the level of detail provided in estimating contract costs and accumulating contract costs. Greater detail in the accumulating and reporting of contract costs than in the pricing of proposals is permitted by CAS 401-40(c) which states that,

> *"The grouping of homogeneous costs in estimates prepared for proposal purposes shall not per se be deemed an inconsistent application of cost accounting practices. . . ."*

Although the grouping of homogeneous costs for estimating purposes is permitted, the auditor should be aware that CAS 401-50(a) requires that:

> *". . . costs estimated for proposal purposes shall be presented in such a manner and in such detail that any significant cost can be compared with the actual cost accumulated and reported therefore."*

In other words, the grouping of costs for proposal purposes does not result in noncompliance as long as the costs are homogeneous and if comparisons between actual costs and proposed costs are possible. The following are examples of permissible grouping of costs as presented in CAS 401-50(a)1 and 3.

> *"...1. Contractor estimates an average direct labor rate for manufacturing direct labor by labor category or function. Contractor records manufacturing direct labor based on actual cost for each individual and collects such costs by labor category or function."*

> *"...3. Contractor uses an estimated rate for manufacturing overhead to be applied to an estimated direct labor base. It identifies the items included in its estimate of manufacturing overhead and provides supporting data for the estimated direct labor base. The contractor accounts for manufacturing overhead by individual items of cost which are accumulated in a cost pool allocated to final cost objectives on a direct labor base."*

c. Noncompliance can occur when there is greater detail in the estimating of contract costs than in the accumulating and reporting of costs as indicated by the following example in CAS 401-60(b):

> *"...5. Contractor estimates engineering labor by cost function, i.e., drafting, production engineering, etc. Contractor accumulates total engineering labor in one undifferentiated account."*

(1) In the above circumstances, should the potential noncompliance with CAS 401 be rectified by providing less detail in estimating or more detail in accumulating costs? If the contractor revises its price proposal and shows the estimate for engineering labor as one amount, it achieves consistency with its method of

accumulating these costs and technically corrects the noncompliance. However, an agreement to eliminate all details in the estimate would deprive the Government of information needed to effectively evaluate the pricing proposal. This extreme approach should be rejected and cited as an estimating system deficiency.

(2) FAR 15.403, DFARS 215.403, and Contract Pricing Reference Guides contain guidance as to the level of detail required for certified cost or pricing data submitted in connection with negotiated noncompetitive contracts. The FAR 15.408, Table 15-2, provides a baseline for the detail to be furnished. If the contractor's estimates are in accordance with this baseline, and are in greater detail than costs in the records, the auditor should normally recommend that costs be accumulated in a manner consistent with the estimate. A reduction in the estimating details would be acceptable only if the contractor's submission satisfies the FAR/DFARS provisions cited above and the requirements of acquisition officials.

(3) In determining the appropriate level of detail for consistent use in estimating and accumulating costs, the auditor should bear in mind that in many instances procuring contracting officers (PCOs) may request contractors to furnish estimates in a special manner. Such a request may require more information than needed for cost accumulation purposes or cause information to be arranged in a way that is not consistent with the manner in which the contractor intends to accumulate the actual costs.

(4) If the auditor finds estimates of significant items of costs in a pricing proposal that will not be comparable with the actual cost accumulated, he or she should discuss the inconsistency with the contractor. The auditor should point out the areas of potential noncompliance and advise the contractor of the audit recommendations she or he proposes to make to the cognizant Federal agency official (CFAO). If the contractor contends that it presented the information in the price proposal for negotiation purposes only and did not intend to accumulate costs in such a manner, the auditor should inform the contractor that she or he will recommend the contracting officer request a cost estimate that summarizes the cost data in a manner compatible with the cost accumulation plan. The auditor should evaluate the cost summaries to determine if sufficient data are presented to meet the requirement of the Request for Proposal. The auditor's opinion on whether the summaries contain an acceptable level of detail for accumulation purposes should be included in the report to the CFAO.

d. The promulgation of CAS 401 raised a question among auditors as to whether applying a percentage factor to proposed material costs to cover expected losses would comply with the standard if the contractor maintained no separate historical loss records. The CASB issued Interpretation No. 1 to CAS 401 (9904.401-61) in 1976 to deal with that particular issue. The interpretation provides that contractors who estimate material losses by applying a percentage factor to a base, such as total material requirements, must support the factor with historical experience. The interpretation does not prescribe the type or level of detail necessary to comply with the standard. Government contracting authorities should decide the amount of statistical or accounting data required based on the individual circumstances. It should be

emphasized that the contractor should be cited for noncompliance whenever factors are applied to totals or subtotals of material requirements, and during contract performance the contractor does not maintain a separate record of the costs represented by the proposed factor. Adding a uniform percentage to each line item in the bill of material is the same as adding a single percentage to the total basic material cost. In the two examples above, the contractor would have to maintain a separate accounting record for the additional material purchased during contract performance to be in compliance with the CAS 401. However, when the contractor adjusts the quantities of individual line items in the bill of material, either by applying a factor or by adding a specific quantity of additional units, the contractor is deemed to have complied with the standard. This is because the estimate is a representation of the total cost of individual parts. In most situations, the cost and quantity of individual parts used can be determined from the accounting records. Nothing in the Interpretation No. 1 to CAS 401 (9904.401-61) should be construed to alter or modify the requirements that the contractor submit adequate certified cost or pricing data. Refer to 9-200 for evaluating the adequacy of certified cost or pricing data in proposals.

8-401.2 Consistency in Reporting Costs **

a. As used in the standard, "Reporting of Costs" refers to:

(1) data presented in reports required by the contract such as budget and management reports for cost control purposes and

(2) data contained on public vouchers or any other request for payment.

b. The primary interest is to ascertain whether the accounting practices used to determine the costs presented in these reports are consistent with the accounting practices used to estimate and accumulate the costs. It would not be expected that a public voucher will contain the same level of detail as a pricing proposal or that the details in a budget or management report will be limited to that in the proposal. The auditor will ascertain whether the accounting practices for selecting indirect cost pools and methods of distributing the indirect costs used to determine the amounts on those reports are consistent with those used for estimating and accumulating. In addition, the standard does not prohibit the use of reporting systems with unique requirements such as the applied cost concept used for EVMS purposes and certain estimating techniques used to project contract estimates at completion under EVMS contracts. Further, the standard does not prevent the use of forecasted indirect cost rates for billing as long as the pools and allocation bases used to develop those rates are consistent with those used for estimating and accumulating costs.

c. If noncompliances are found, the auditor must ascertain their significance and make the appropriate recommendation as outlined in 8-302.7.

8-401.3 Illustrations **

The following illustrations are intended to supplement those in paragraph 401-60 of the standard. They are to be used as a guide in determining the contractor's

compliance with the standard.

a. **Problem.** A contractor's proposal shows the cost of engineering labor by class, i.e., Engineer I, Engineer II, etc. However, it is the contractor's practice to accumulate engineering labor by type, i.e., Electrical Engineer, Design Engineer, etc. Such practices would violate CAS 401.

Solution. If the contractor submits a summary of the proposal by type of engineer that:

(1) reconciles with the proposed cost by class of engineer,

(2) meets the requirements of the solicitation (for example, the format provided in FAR 15.408, Table 15-2), and

(3) further explains that this is the manner in which cost will be accumulated, then consistency with CAS 401 will have been achieved.

The auditor should be careful to determine whether the PCO intended to buy a specific number of hours by class of engineers. In such a case, the contracting officer should require the contractor to estimate and accumulate by the same classes of engineers. By this requirement, consistency with the cost accumulation records will be achieved without diminishing the level of detail in the estimate. In this regard, it should be remembered that any special breakdown required by the contracting officer is a matter for discussion between the contracting parties and is not dealt with by CAS 401.

b. **Problem.** A contractor estimates cost by line item, i.e., data, first article test, and hardware, and then submits a single proposal for all three items. The contractor does not intend to accumulate the cost of each item separately but rather, in accordance with its established accounting practice, accumulate labor, material, and indirect costs for the contract as a whole. In this instance, the contractor's accumulation records are in lesser detail than its estimating constituting a noncompliance with CAS 401.

Solution. (1) An acceptable approach to correcting the apparent inconsistency between the estimating and accumulating practices is to require the contractor to develop an estimate in accordance with the requirements of the solicitation, for example, FAR 15.408, Table 15-2. Where the contractor elects to estimate and accumulate the combined costs of the three line items by cost elements (direct labor, material, indirect costs, etc.), such a practice does not necessarily constitute a violation of CAS 401. This is true because the level of detail required by FAR 15.408, Table 15-2, has been authoritatively established as an acceptable baseline for compliance with the standard. However, when the contractor chooses this alternative, the contracting officer should be promptly advised in the event that a level of detail of costs incurred that go beyond the essential requirements of CAS 401 is needed for proper contract administration.

(2) On the other hand, if the contractor is required to submit a separate

proposal for individual contract line items and the cost of each item is material in amount and inherently distinct from other items for which costs are separately accumulated, the contractor probably should be required to accumulate cost by line items. In effect, where required by the contracting officer, the cost of each line item should be estimated and accumulated as if each were a separate contract. Examples of contracts whose costs should be estimated and accumulated in such a way are those that provide for:

(a) design, prototype development, and production, or

(b) distinct and disparate end items of production.

c. **Problem.** A contractor prepares separate estimates for the cost of raw material, subcontracts, purchased parts, and interdivisional transfers. The costs of these items are not separately identified in the accounting records.

Solution. The practice is in noncompliance with the standard and the contractor should be required to accumulate costs consistent with its estimates. However, the standard permits supplemental records if they are reconcilable to the formal accounting records.

d. **Problem.** During the audit of a price proposal, an auditor finds that a contractor uses a material additive factor to cover the cost of small common-usage items. In preparing the price proposal, the cost of this factor is estimated as an historical percentage of direct material requirements. In accumulating costs, these items are computed as a percentage of direct productive labor hours.

Solution. The condition described above contravenes the provisions of CAS 401. The auditor should recommend a determination of noncompliance and that the contractor change its actual practices to conform with the practices disclosed or established. For example, if the contractor's disclosed or established practice is to accumulate the cost of small common-usage items as a percentage of direct productive labor hours, then the estimating practice should be changed to be compatible with the method of accumulating such costs. In the price evaluation report, the excess cost estimated as a direct result of using a practice that is inconsistent with the contractor's disclosed or established practices will be quantified and questioned. The validity of alternative methods of estimating and costing will be determined in accordance with guidelines included in 6-300 and 9-400.

8-402 Cost Accounting Standard 402 - Consistency in Allocating Costs Incurred for the Same Purpose **

a. The purpose of this standard is to ensure that each type of cost is allocated only once and on only one basis to any contract or other cost objective. The fundamental requirement is that all costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only with respect to final cost objectives. The standard was effective and applicable to all CAS-covered contracts awarded after July 1, 1972.

b. The key words in applying this standard are "costs incurred for the same purpose in like circumstances". The illustrations in CAS 402-60 show the need for a thorough examination of the facts before concluding whether or not an accounting practice is resulting in noncompliance with the standard. For example, CAS 402-60(b)(2)) demonstrates how a cost, although incurred for the same general purpose, (e.g., fire fighting) should be viewed in terms of its more specific purposes (i.e., protection of the entire plant versus protection of a special area) which permits the costs to be allocated to final costs objectives in a different manner. It is essential to examine all of the facts and to avoid making determinations on the basis of general information or nomenclature.

c. CAS 401-30(a)(6) defines a proposal as: "any offer or other submission used as a basis for pricing a contract, contract modification or determination settlement or for securing payments thereunder". Interpretation No. 1 to CAS 402 (9904.402-61) was promulgated in 1976 to clarify the circumstances under which a contractor could charge proposal costs both direct and indirect without violating the standard. The interpretation concludes that not all proposal costs are incurred in like circumstances. Proposal costs incurred pursuant to the specific requirement of an existing contract, such as proposal cost incurred in connection with the definitization of letter contracts and orders issued under basic ordering agreements, are considered to have been incurred in a different circumstance than other proposal costs and may be charged direct to the specific contract. Costs of preparing proposals will be treated as indirect costs except where such effort is specifically required by contract provision.

d. If noncompliances are found, the auditor must ascertain their significance and make the appropriate recommendations as outlined in 8-302.7.

8-402.1 Illustrations **

The following illustrations supplement those in section 402.60. They are to be used as a guide in determining whether the contractor complies with the standard.

a. **Problem.** A contractor has a Government contract that requires extra effort for planning and cost management. It hired extra people to accomplish this effort and accounted for all their labor cost as a direct charge to the contract. The contractor has other people performing the same functions for more than one contract and their labor is charged to indirect costs.

Solution. Since the work being performed is the same and the only difference is in the amount of effort required to accomplish the function, this practice would not comply with the standard. The contractor could correct the situation by:

(1) charging all of these costs to indirect costs and developing an equitable distribution base, or

(2) charging all of these costs as direct costs.

b. **Problem.** A contractor charges engineering consultant costs incurred on IR&D

projects to engineering overhead; the same costs incurred for research and development contracts are charged direct to the contracts.

Solution. This practice does not comply with the standard because the same type of costs incurred in similar circumstances are charged to cost objectives on different bases. Also, the practice does not comply with FAR 31.205-18, and CAS 420 which requires that direct and indirect costs for IR&D projects be determined on the same basis as if the IR&D projects were under contract. Since the benefiting projects can be specifically identified, the consultant costs should be charged directly to those projects.

c. **Problem.** A contractor has hundreds of cranes located throughout a shipyard. Their maintenance, taxes, and depreciation costs are recorded in a general account and then allocated to departmental overhead pools for distribution to contracts. The Dry Dock has the cost of eight cranes charged directly to its departmental overhead pool because their use is unique to the Dry Dock operations.

Solution. Since the Dry Dock cranes are used for a special purpose and the Yard cranes for general purposes, this practice would not result in double counting. However, if any of the Yard cranes are also used for a special purpose, such as new ship construction, the practice would result in double counting and noncompliance with the standard. Under those conditions, all of the special purpose cranes should be eliminated from the general account and charged directly to the using department to correct the problem.

8-403 Cost Accounting Standard 403 - Allocation of Home Office Expenses to Segments **

a. The purpose of this standard is to establish criteria for allocation of home office expenses to the segments of the organization on the basis of a beneficial or causal relationship. The appropriate implementation of this standard will limit the amount of home office expenses classified as residual to the expenses of managing the organization as a whole.

b. The standard was effective July 1, 1973 and, after receipt of a CAS-covered contract, is to be followed by each contractor as of the beginning of its next fiscal year. The standard exempts contractors who are subject to the provisions of Office of Management and Budget Circular No. A-21 (Principles for Determining Costs Applicable to Research and Development under Grants and Contracts with Educational Institutions) and Circular No. A-87 (Principles for Determining Costs Applicable to Training and Other Educational Services under Grants and Contracts with State and Local Governments).

8-403.1 General **

a. With the adoption of this standard, contractor and Government personnel have a specific, authoritative accounting rule prescribing criteria for allocating home office and group office expenses to segments of an organization. For purposes of the

standard, the term "home office" is defined in CAS 403-30(a)(2) as an "office responsible for directing or managing two or more but not necessarily all segments of an organization". The definition expressly includes intermediate levels, such as group organizations that report to a common home office. An intermediate level may be both a segment and a home office.

b. The basic concept of the standard recognizes that some home office expenses incurred for specific segments can be assigned directly. Other expenses, not incurred for specific segments, have a clear relationship (i.e., measurable with reasonable objectivity) to two or more segments. Lastly, the standard recognizes a third type of home office expense (i.e., residual) which possesses no readily measurable relationship to segments. Consistent with this concept of home office expenses the standard requires that:

(1) Those expenses incurred for specific segments are to be allocated directly to those segments to the maximum extent practical.

(2) Those expenses not directly allocable, but possessing an objective measurable relationship to segments, should be grouped in logical and homogeneous expense pools and distributed on allocation bases reflecting the relationship of the expenses to the segments concerned.

(3) When the residual expenses are considered material because they exceed a specified percentage of total company operating revenue (as defined in CAS 403-40(c)(2)), a three-factor formula must be used to allocate these expenses. The three-factor formula consists of payroll dollars, operating revenue (net of interdivisional purchases), and average net book values of tangible capital assets and inventories (net of progress payment billings). If the residual expenses do not exceed this threshold, they may be allocated to all segments by means of any allocation base representing the total activity of such segments. Regardless of the method, there may be instances where a particular segment receives significantly more or less benefit from residual expenses than would be reflected by the allocation of such expenses pursuant to the standard. In these cases, a special allocation may be agreed to by the parties provided such special allocation is commensurate with the benefits received (see CAS 403-40(c)(3)). When a special allocation under CAS 403-40(c)(3) is used, it must be described in the contractor's Disclosure Statement. Otherwise, the contractor would be in noncompliance for failure to follow its disclosed practices.

c. A requirement of the standard is that home office expenses shall be allocated on the basis of the beneficial or causal relationship between supporting and receiving segments. In establishing this requirement, the CASB stated that materiality is an important consideration in determining whether an expense should be allocated directly or accumulated in a homogeneous expense pool and allocated on a basis reflecting the causal or beneficial relationship of the pooled expenses to the receiving segments. In addition, CAS 403-40(b) provides criteria for allocating six groupings of home office expenses. Residual expenses are defined in CAS 403-40(c) as all home office expenses which are not otherwise allocable pursuant to the standard.

d. The standard provides for an annual test to ascertain whether the residual expenses must be allocated on the basis of the prescribed three-factor formula or if the contractor may use any appropriate base. For the first year the contractor is subject to this standard the determination "shall be based on the pro forma application of this standard to the home office expenses and aggregate operating revenue for the contractor's previous fiscal year" (CAS 403-40(c)(2)). The contractor is responsible for determining whether or not the company should propose the use of any base representative of the total activity of the segments or if the three-factor formula must be used. The pro forma submission must comply with the standard.

8-403.2 Guidance **

a. Contractors becoming subject to this standard must:

(1) Revise their home office expense pool structure and methods of distributing the expenses where necessary to comply with CAS 403.40.

(2) Amend Disclosure Statements to describe the new pool structures and methods of distribution.

(3) Estimate the cost of the first and all subsequent contracts subject to this standard using the new pool structures and methods of distribution. Failure to do so would result in noncompliance with CAS 401 when costs are subsequently recorded in accordance with CAS 403.

(4) Submit a proposal for the equitable adjustment of all CAS-covered contracts that were negotiated before the effective date of the standard and are affected by the change in cost accounting practices.

b. Amendments to a Disclosure Statement are subject to the same audit and reporting requirements as the original Disclosure Statement. Auditors should be especially careful in evaluating the adequacy of responses to Item 8.3.2 of the Disclosure Statement concerning the composition of the allocation base. The description should provide enough information to determine that the contractor is treating all of the elements in the base in the same manner at all divisions.

c. To ascertain that the accounting practices comply with the standard, the auditor should determine that:

(1) expenses have been properly classified as directly allocable, indirectly allocable, or residual,

(2) "logical and relatively homogeneous pools" are "allocated on bases reflecting the relationship of the expenses to the segments concerned", and

(3) residual expenses are allocated on a base "representative of the total activity" of the company or the prescribed three-factor formula.

d. Appropriate steps must be included in all audits, i.e., price proposals, forward pricing rate proposals, defective pricing, etc., to assure that adjustments were made for the changes in the accounting practices.

e. Because changes in the home office accounting practices will normally affect more than one organizational unit of the company, arrangements should be made by the CAC, CHOA, or GAC as soon as possible to coordinate the audits of the price adjustment proposal.

f. Auditors should encourage contractors becoming subject to the standard to submit their Disclosure Statement revisions and a pro forma submission of their revised home office expense structure as soon as possible. The early submission and audit of this data could permit the contractor and auditor to resolve any significant problems before the contract award due dates and thereby preclude delays in the awarding of contracts.

g. This standard requires contractors to use a base representative of the total activity of the segments for distributing residual expenses, unless the criteria for special allocation or for the three-factor formula method are met. If the residual expenses exceed the levels in CAS 403-40(c)(2), the contractor must distribute them on the basis of the three-factor formula beginning with the next fiscal year. In addition, the contractor may also choose to use the three-factor formula even though not required by the standard. The first time the contractor must use the three-factor formula, it may submit a proposal for an equitable adjustment. After the contractor uses the three-factor formula for the first time, any change to the base for distribution of the residual expenses, is subject to not only the provisions of this standard but also the provisions of CAS 401 and FAR 52.230-2, paragraphs (a)(4)(ii), (a)(4)(iii), or (a)(5). The prefatory comments to CAS 420 state that the amount of IR&D and B&P costs at a home office is not to be added to the residual pool to determine whether use of the three-factor formula is required. Where the three-factor formula is not required to be used, selection of an appropriate base should consider the effect of CAS 420-50(e)(2) which, in certain circumstances, ties the allocation of IR&D and B&P costs to the home office residual expense allocation base.

h. If noncompliances are found, the auditor must ascertain their significance and make the appropriate recommendations as outlined in 8-302.7.

8-404 Cost Accounting Standard 404 - Capitalization of Tangible Assets **

a. This standard establishes criteria for determining the acquisition costs of tangible assets that are to be capitalized. CAS 404 does not cover depreciation or disposition of fixed assets, which is covered by CAS 409.

b. The initial standard was effective July 1, 1973 and, after the receipt of a CAS-covered contract, must be applied to all tangible capital assets acquired during the contractor's next fiscal year. On February 13, 1996, the CAS Board amended CAS 404-50(d)(1) relating to the measurement of assets acquired through mergers or business

combinations. The CAS Board also amended CAS 404-40(b)(1) to increase the minimum acquisition cost for capitalization of tangible capital assets from $1,500 to $5,000. The effective date of these amendments is April 15, 1996. The amendments are applicable to contracts in the next cost accounting period beginning after receipt of a contract that incorporates the revised standard. Amendments to CAS 409, also effective April 15, 1996, are discussed in 8-409.

c. The amended CAS 404, effective April 15, 1996, applies to tangible capital assets acquired in a business combination that takes place after the applicability date (see 8-404.4 for illustrations of the amended CAS 404 and 409 applicability date).

8-404.1 General **

a. The standard requires contractors to capitalize the acquisition cost of tangible assets in accordance with a written policy that is reasonable and consistently applied. The policy shall include the following:

(1) A minimum service life criterion which shall not exceed two years but which may be a shorter period.

(2) A minimum acquisition cost criterion which shall not exceed $5,000 but which may be a smaller amount.

(3) Identification of asset accountability units to the maximum extent practical. The standard defines these units as “A tangible capital asset which is a component of plant and equipment that is capitalized when acquired or whose replacement is capitalized when the unit is removed, transferred, sold, abandoned, demolished, or otherwise disposed of”. These units should be identified and separately capitalized upon acquisition. Even though they may not have been separately capitalized, the units should be removed from the asset accounts at disposition.

(4) Establishment of minimum dollar amounts for the capitalization of original complements of low cost equipment and for betterments and improvements. These minimum amounts may exceed the $5,000 limitation provided the higher limitations are reasonable in the contractor's circumstances. The primary purpose in requiring the capitalization of original complements is to assure allocation of incurred cost to applicable current and future periods. The total original complement should be treated as a tangible capital asset. Therefore, the CASB expected that a contractor will identify and control the original complement as an entity rather than account separately for each individual item which comprises the total complement.

b. The acquisition cost of tangible assets includes the purchase price adjustment to the extent practical for premiums paid or discounts received and the costs necessary to prepare the asset for use.

(1) CAS 404-50(a)(1)(i) states that the purchase price is the consideration given in exchange for an asset and is determined by cash paid or to the extent payment is not paid in cash, in an amount equivalent to what would be the cash basis. This

provision requires the gain or loss realized on assets traded-in to be included as part of the purchase price of the acquired asset. CAS 404 does not permit alternative treatment.

(2) Costs necessary to prepare the asset for use include the cost of placing the asset in location and bringing the asset to a condition necessary for normal or expected use. Where material in amount, such costs including initial inspection and testing, installation, and similar expenses shall be capitalized.

(3) Donated assets which meet the contractor's criteria for capitalization shall be capitalized at their fair value. This requirement also includes those assets donated by the Federal Government.

c. Tangible capital assets constructed or fabricated by a contractor for its own use shall be capitalized at amounts that include all indirect costs properly allocable to such assets. This requires the capitalization of G&A expenses and the cost of money when such expenses are identifiable with the constructed asset and are material in amount. Application of the full costing techniques to Government contract costing requires that full consideration be given to the applicability of fixed overhead including G&A expenses and the cost of money to constructed assets. Therefore, constructed tangible capital assets that are identical with or similar to the contractor's normal product should receive an appropriate share of all indirect cost including G&A expenses and the cost of money. In addition, other constructed tangible capital assets requiring significant indirect support also should be burdened with their allocable share of these supporting indirect costs including supporting G&A expenditures, where such costs are material.

d. The provisions of the standard do not apply to special tooling and special test equipment that are properly chargeable against the contracts for which the acquisition is authorized.

e. In connection with lease agreements, contractors must determine whether they consider the acquisition to be a capital lease under FASB Statement No. 13 and subject to the standard or an operating lease under FASB Statement No. 13 and subject to the requirements of FAR 31.205-36. In either case, the CASB has stated that the reasonableness of the lease costs remains the responsibility of the acquisition agencies.

f. The standard does not extend to the specific type of records to be maintained. Therefore, contractors may continue to account for their assets on a unit basis or in logical groups in accordance with other appropriate regulations.

g. If noncompliances are found, the auditor must ascertain their significance and make the appropriate recommendations as outlined in 8-302.7.

8-404.2 Assets Acquired in a Business Combination Using the Purchase Method of Accounting. **

a. Pre-April 15, 1996 Requirements. Fully CAS-covered contractors would

measure the assets acquired in a business combination using the purchase method of accounting required by the original CAS 404-50(d) (i.e., step-up or step-down of asset bases), but depreciation expense would be subject to the allowability ceiling of FAR 31.205-52 (Selected Areas of Cost Guidebook, Chapter 8). The FAR 31.205-52 ceiling amount is the amount that would have been allowable had the business combination not taken place (i.e., no step-up of asset values). Accordingly, the unallowable depreciation expense (i.e., excess depreciation based on a stepped-up asset value over depreciation based on no stepped-up asset value) should be included in any allocation base which normally includes such costs, e.g., the total cost input G&A base. See 8-410.1a(2) for further guidance.

b. Requirements Effective April 15, 1996. The prior CAS 404.50(d) was deleted and replaced by an amended CAS 404.50(d)(1) and (2).

(1) CAS 404-50(d)(1):

(a) CAS 404-50(d)(1) provides that all tangible capital assets of the acquired company, that during the most recent cost accounting period prior to a business combination generated either depreciation expense or cost of money charges that were allocated to Federal Government contracts or subcontracts negotiated on the basis of cost, be capitalized by the buyer at the net book value(s) of the asset(s) as reported by the seller at the time of the transaction.

(b) The requirements of CAS 404-50(d)(1) deviate from the purchase method of accounting required by GAAP, and instead, provide “no step-up, no step-down” of asset values for Government contract cost accounting purposes. Consequently, the buyer will use the net book value of the tangible capital asset in the seller’s accounting records as the capitalized value of the asset and for all contract costing purposes. For instance, depreciation expense will be based on the seller’s net book value. Likewise, cost of money will be calculated using the seller’s net book value. Further, the asset values used in the CAS 403 three-factor formula for distributing the home office costs will be based on the seller’s net book value.

(2) CAS 404-50(d)(2):

(a) CAS 404-50(d)(2) applies to tangible capital assets acquired in a business combination that did not generate either depreciation expense or cost of money charges during the most recent cost accounting period. CAS 404-50(d)(2) provides that all tangible capital assets of the acquired company, that during the most recent cost accounting period prior to a business combination did not generate either depreciation expense or cost of money charges that were allocated to Federal Government contracts or subcontracts negotiated on the basis of cost, are to be assigned a portion of the cost of the acquired company not to exceed their fair values at the date of acquisition. When the fair value of identifiable acquired assets, less the liabilities assumed, exceeds the purchase price of the acquired company in an acquisition under the “purchase method” the value otherwise assignable to tangible capital assets shall be reduced by a proportionate part of the excess.

(b) The requirements of CAS 404-50(d)(2) are similar to the purchase method of accounting required by GAAP. Consequently, tangible capital asset values would be written-up or written-down depending on the circumstances of the transaction. However, tangible capital assets meeting the requirements of CAS 404.50(d)(2) must still comply with the requirements of FAR 31.205-52 (Selected Areas of Cost Guidebook, Chapters 8 and 19). Therefore, although the asset values may be measured based on the “step-up” or “step-down” rule, allowable depreciation and cost of money will be limited to the total of the amounts that would have been allowed had the combination not taken place (i.e., costs resulting from asset write-ups are unallowable). This limitation was removed by FAC 97-04, effective April 24, 1998, which revised FAR 31.205-52 and 31.205-10(a)(5) to conform to the revised CAS 404 and 409. Therefore, allowable depreciation and cost of money would be measured in accordance with CAS 404-50(d).

8-404.3 Illustrations - Compliance with the Standard **

The following illustrations are intended to supplement the illustrations in paragraph 404-60 of the Standard. They are to be used as a guide in determining if noncompliance exists.

a. **Problem.** A contractor has an established policy of capitalizing tangible assets that have a service life in excess of two years and a cost of more than $6,500. It enters into a contract that makes it subject to this standard.

Solution. The contractor must change its policy to conform to the maximum limitations of not more than two years and $5,000. If costs are affected on CAS-covered contracts in existence before the requirement for the contractor to follow this standard, they are subject to the equitable adjustment provision of FAR 52.230-2(a)(4)(i).

b. **Problem.** A contractor has an existing policy of capitalizing tangible assets that have a service life of more than one year and a cost of more than $3000. It enters into a contract that makes it subject to the standard and suggests that the capitalization policy should be changed to two years and $5,000.

Solution. The contractor's existing policy is in conformance with the provisions of the standard. Therefore, it is not required to make any changes to the policy. However, if it should choose to do so, the change must be made in accordance with the provisions of FAR 52.230-2(a)(4)(ii). Under that paragraph, the change may not result in any increased cost to the Government.

c. **Problem.** A contractor has a policy of capitalizing betterments and improvements when the expenditures exceed five percent of the current replacement value of buildings or 25 percent of the current replacement value of machinery and equipment. The policy does not contain any dollar limitations.

Solution. CAS 404-40(b)(4) of the standard provides that "The contractor's policy may designate higher minimum dollar limitations... for betterments and

improvements than the limitation established in accordance with paragraph (b)(1) of this section, provided such higher limitations are reasonable in the contractor's circumstances". Since the contractor's policy does not contain specific dollar limits, it does not comply with the standard. To correct the situation, the contractor could add specific not-to-exceed dollar limitations. Betterments and improvements whose values are in excess of the established limitations would be capitalized without regard to the percentage relationship. However, the dollar limitations established by the contractor must be reasonable in its circumstances.

d. **Problem.** An asset having a net book value of $1.5 million and cash of $1 million is given in exchange for the acquisition of a new asset commonly sold for $2 million. The contractor's policy is to capitalize the replacement as the sum of the cash paid and the net book value of the old asset.

Solution. The contractor's policy does not comply with the standard. CAS 404-50 (a)(1)(i) requires the contractor to determine the amount equivalent to the cash price. The acquisition cost in this instance would be $2 million. The contractor is required to remove the undepreciated value of the traded asset from the asset accounts and capitalize the replacement asset for $2 million.

e. **Problem.** A contractor proposes to construct a facility and install equipment for the Government. The proposed price does not include an allocation of G&A expenses or cost of money. However, G&A expenses are allocated to similar facilities constructed or fabricated by the contractor for its own use.

Solution. CAS 404 applies only to tangible capital assets acquired or constructed for the contractor's own account. Assets provided by a contractor in fulfilling contract terms are not covered by this standard. However, even though facilities contracts are not subject to CAS 404, they should be allocated G&A expense under CAS 410. In addition, cost of money should be considered an allowable cost under FAR 31.205-10.

f. **Problem.** The contractor manufactures Model X for the Government. The contractor produces one unit of Model X for its own use. The contractor capitalized the asset at $37,500 ($25,000 material, $5,000 production labor and $7,500 overhead, reflecting the 150 percent annual overhead rate).

Solution. Model X was not capitalized in accordance with CAS 404-50(b). When constructed assets are identical with the contractor's regular product, such assets must be allocated their full share of indirect costs, including G&A expenses and cost of money. Assuming that G&A expenses, production overhead cost of money, and G&A expense cost of money rate for the year are 10%, 10% and 1% respectively, the asset should have been capitalized at $42,180, computed as follows:

Cost Element	Indirect Expense Rate	Assignment of Cost

Production Labor		$5,000
Production Overhead	(150%)	7,500
Cost of Money related to Production Overhead	(10%)	500
Materials		25,000
Subtotal		38,000
G&A Expense	(10%)	3,800
Cost of Money related to G&A Expense	(1%)	380
Total cost to be capitalized		$42,180

g. **Problem.** Contractor A acquires Contractor B and accounts for the business combination using the purchase method of accounting. Prior to the business combination, the net book value of Contractor B's assets was $10.5 million. Contractor B's assets generated depreciation expense and cost of money charges that were allocated to Government contracts negotiated on the basis of cost in its most recent cost accounting period. For GAAP purposes, Contractor A recorded the assets at their fair market value of $18 million. The revised CAS 404 applies to the business combination.

Solution. The provisions of the amended CAS 404-50(d)(1) would apply to the business combination because the seller's (Contractor B's) assets generated depreciation or cost of money charges that were allocated to Government contracts negotiated on the basis of cost in its most recent cost accounting period. For CAS purposes, Contractor A would capitalize the acquired assets at $10.5 million, the net book value of the assets in Contractor B's accounting records. The $10.5 million would be used as the basis of Contractor A's depreciation expense, cost of money, and asset values used in the CAS 403 three-factor formula. The $7.5 million difference between the net book value and fair market value would not be questioned because the costs were not "measured" for CAS purposes. Consequently, any depreciation related to the $7.5 million would not be included in Contractor A's total cost input G&A base.

h. **Problem.** Same facts as Problem g. above, except that Contractor B has not performed Government contracts for several years and consequently, its assets did not generate depreciation expense or cost of money charges that were allocated to Government contracts negotiated on the basis of cost, in its most recent cost accounting period.

Solution. The provisions of the amended CAS 404-50(d)(2) would apply to the

business combination because the seller's (Contractor B's) assets did not generate depreciation expense or cost of money charges on Government contracts in its most recent cost accounting period. For CAS purposes, Contractor A would capitalize the acquired assets at $18 million, the fair market value of Contractor B's assets. However, for contracts awarded prior to April 24, 1998, costs resulting from the $7.5 million fair market value in excess of the net book value are unallowable in accordance with the provisions of FAR 31.205-52. Consequently, the allowable depreciation and cost of money charges would be based on the $10.5 million. The asset values used for the CAS 403 three-factor formula would be the CAS 404 measured amount of $18 million. The unallowable $7.5 million would be included in any of Contractor A's allocation bases which normally include such costs, e.g., the total cost input G&A base, because the CAS 404 measured cost is the fair market value of $18 million, even though the FAR 31.205-52 allowable ceiling amount is based on the asset value of $10.5 million. For contracts awarded on or after April 24, 1998, the allowable depreciation and cost of money would be based on $18 million in accordance with the revised FAR 31.205-52.

8-404.4 Illustrations - Applicability Date of Amended CAS 404/409, Effective April 15, 1996 **

The following illustrations are intended to demonstrate the applicability date of the amended CAS 404/409, effective April 15, 1996.

a. **Situation**. Contractor A uses a calendar year as its accounting period and receives its "first" CAS-covered contract on May 20, 1996, after the April 15, 1996 effective date of the revised CAS 404/409. Contractor A completes a business combination using the "purchase method" of accounting on February 15, 1997.

Applicability Date. The applicability date of the revised CAS 404 and 409 would be January 1, 1997, the beginning of Contractor A's next full cost accounting period beginning after receipt of a contract to which the revised CAS 404 and 409 is applicable. Assets acquired in the business combination would be subject to the revised CAS 404 and 409 because the combination takes place after the applicability date of the revised CAS 404/409.

b. **Situation**. Same facts as a. above, but Contractor A completes the business combination on June 15, 1996.

Applicability Date. As explained in a. above, the applicability date of the revised CAS 404/409 is January 1, 1997. Accordingly, the business combination would not be subject to the revised CAS 404/409 because the combination was completed prior to the applicability date.

c. **Situation**. Contractor B uses a cost accounting period of July 1 - June 30 and receives its "first" CAS-covered contract on December 10, 1996, after the April 15, 1996 effective date of the revised CAS 404/409. Contractor B completes a business combination using the "purchase method" of accounting on January 30, 1997.

Applicability Date. The applicability date of the revised CAS 404/409 would be

July 1, 1997, the beginning of Contractor B's next full cost accounting period after receipt of a contract (December 10, 1996) to which the revised CAS 404/409 is applicable. The business combination would not be subject to the revised CAS 404/409 because the combination was completed prior to the July 1, 1997 applicability date.

d. **Situation**. Contractor C uses a calendar year as its cost accounting period. Prior to 1996, Contractor C was awarded contracts subject to full CAS coverage. During 1996, Contractor C became subject to only modified CAS coverage and received a modified CAS-covered contract on May 15, 1996. Contract C completes a business combination on February 15, 1997.

Applicability Date. Contractor C would not be subject to the revised CAS 404 and 409 because it did not receive a contract subject to full CAS coverage after the April 15, 1996 effective date of the revised CAS 404 and 409. Although Contractor C may continue to perform contracts awarded in prior accounting periods that are subject to full CAS coverage, these contracts would not be subject to the revised CAS 404 and 409.

8-405 Cost Accounting Standard 405 - Accounting for Unallowable Costs **

The purpose of this standard is to facilitate the negotiation, audit, administration, and settlement of contracts. It contains guidelines on:

(1) identification of costs specifically described as unallowable, at the time such costs first become defined or authoritatively designated as unallowable, and

(2) the cost accounting treatment to be accorded such identified unallowable costs to promote the consistent application of sound cost accounting principles covering all incurred costs.

The standard does not govern the allowability of costs, which is a function of the appropriate acquisition or reviewing authority. The standard was effective April 1, 1974, and is applicable to all CAS-covered contracts awarded after that date.

8-405.1 General **

a. Costs expressly unallowable or mutually agreed to be unallowable, including costs mutually agreed to be unallowable directly associated costs, shall be identified and excluded from any billing, claim, or proposal applicable to a Government contract. An expressly unallowable cost is that which is specifically named and stated to be unallowable by law, regulation, or contract.

b. Costs specifically designated as unallowable or as directly associated unallowable costs in a written decision of a contracting officer pursuant to contract disputes procedures shall be identified if included or used in computing any billing, claim, or proposal applicable to a Government contract.

c. Costs which are stated to be unallowable in a written decision issued by a contracting officer pursuant to disputes clause procedures are required to be identified

by the contractor. This includes costs claimed by a contractor to be allowable but stated by a contracting officer in a written decision to be unallowable because the costs are not allocable costs of the contract under which they are being claimed. Therefore if the contractor fails to identify claimed costs determined by the contracting officer to be unallowable because they are not allocable, the contractor is in noncompliance and the procedures in CAS 405 should be followed. (See CAS Working Group Paper 77-13.)

d. A directly associated cost is any cost which is generated solely as a result of another incurred cost and which would not have been incurred otherwise.

e. Guidance concerning accounting for unallowable costs and directly associated costs is set forth in FAR 31.201-6.

f. The costs of any work project not contractually authorized, whether or not related to a proposed or existing contract, shall be accounted for separately from costs of authorized work projects.

g. All unallowable costs shall be subject to the same cost accounting principles governing cost allocability as allowable costs.

(1) In circumstances where these unallowable costs normally would be part of a regular indirect cost allocation base or bases, they shall remain in such base or bases. This provision is based on the concept that ". . . the issues concerning cost allocation and those relating to cost allowance are distinct and separate. Allowability should not be a factor in the selection or in the determination of the content of an allocation base used to distribute a pool of indirect costs. The appropriateness of a particular allocation base should be determined primarily in terms of its distributive characteristics. Any selective fragmentation of that base which eliminates given base elements for only some of the relevant cost objectives would produce a distortion in the resulting allocations". (See 8-410.1a(2))

(2) Where directly associated costs are part of an indirect cost pool that will be allocated over a base containing the unallowable cost with which it is associated, they shall remain in the pool and be allocated through the regular allocation process. According to the CASB, to do otherwise under these circumstances, could result in double counting.

h. The standard does not specify the nature of records required except that they be adequate to establish and maintain visibility of identified unallowable costs (including directly associated costs), their accounting status in terms of their allocability to contract cost objectives, and their cost accounting treatment. Unallowable costs do not have to be identified when, based upon considerations of materiality, the Government and the contractor agree on an alternate method that satisfies the purpose of the standard.

i. If noncompliances are found, the auditor must ascertain the significance of the problem and make recommendations as outlined in 8-302.7.

8-405.2 Illustrations **

The following illustrations are intended to supplement those in paragraph 405-60 of the standard. They will help auditors determine if the contractor is complying with the standard.

a. **Problem.** For the past several years, an auditor has questioned the allowability of part of the costs in a contractor's business luncheon account as entertainment expenses. The final cost questioned as negotiated by the contracting officer for those years has always included a large portion of the amount the auditor recommended for disapproval. In estimating the new forward pricing and provisional billing rates, the contractor reduced the estimated rates in anticipation of similar cost questioned. The contractor rates are based on a projection of cost incurred in prior years.

Solution. CAS 405-50(c) permits the Government and the contractor to agree on a method, other than specific identification, as long as that method satisfies the standard. If applicable, the Disclosure Statement should be amended to reflect this.

b. **Problem.** Another contractor under circumstances similar to those above declines to adjust the estimated forward pricing and provisional billing rates.

Solution. The auditor should report this noncompliance with the standard as described in 8-302.7.

c. **Problem.** A contractor performed some unauthorized work under a cost type prime contract. The contracting officer decided to disallow the cost (direct and indirect cost) specifically related to the unauthorized work. The contractor adjusted the accounting records and the billings to identify the unallowable production costs. However, in calculating the G&A total cost input base, the contractor excluded the unallowable contract cost. It stated that the incurred cost for unauthorized work did not affect the amount of G&A expenses incurred; consequently, the contractor should be permitted to recover its total G&A expense pool.

Solution. The auditor should report this to the contracting officer as noncompliance with CAS 405-40(d) and (e).

d. **Problem.** The contractor's established practice is to include overtime premium applicable to direct and indirect labor in overhead. The contractor allocates total overhead to total direct labor. The contractor performs, and separately accounts for, certain direct labor associated with a work project which a Government contract specifically does not authorize. Both the unauthorized and authorized projects under the contract required overtime work. The contractor computes the overhead rate applicable to final billing under the contract by including overtime premium applicable to all work projects in the overhead pool and direct labor applicable to all work projects in the base.

Solution. The contractor complies with CAS 405-40(e) since it separately accounts for costs of unauthorized and authorized work projects. Also, the contractor's overhead rate computation complies with CAS 405.40(e) which states,

"Where a directly associated cost (overtime premium, in this illustration) is part of a category of costs normally included in an indirect cost pool that will be allocated over a base containing the unallowable cost with which it is associated, such a directly associated cost shall be retained in the indirect cost pool and be allocated through the regular allocation process".

8-406 Cost Accounting Standard 406 - Cost Accounting Period **

The purpose of this standard is to provide criteria for selecting the time periods to be used as cost accounting periods for contract cost estimating, accumulating, and reporting. It will reduce the effects of variations in the flow of costs within each cost accounting period. It will also enhance objectivity, consistency, and verifiability and promote uniformity and comparability in contract cost measurements. The standard was effective July 1, 1974 and must be applied in the next fiscal year after receipt of a CAS-covered contract.

8-406.1 General **

a. The cost accounting period used by a contractor must be either (1) its fiscal year or (2) a fixed annual period other than its fiscal year if agreed to by the Government. Where a contractor's cost accounting period is different from the reporting period used for Federal income tax reporting purposes, the latter may be used for such reporting. All rates used for estimating, accumulating, and reporting (including public vouchers and progress payment billings) must be based on the contractor cost accounting period.

b. A transitional cost accounting period other than a year shall be used whenever a change of fiscal year occurs. It may be a period more or less than a year, but not more than 15 months.

c. Costs of an indirect function which exist for only a part of a cost accounting period may be allocated to cost objectives of that same part of the period. However, such cost must be material, accumulated in a separate indirect cost pool, and allocated on the basis of an appropriate direct measure of the activity or output of the function during that part of the period.

d. The same cost accounting period shall be used for accumulating costs in an indirect cost pool as for establishing its allocation base. However, in the prefatory comments the Cost Accounting Standards Board stated that although as a matter of principle it does not agree that mismatched periods are proper, it recognizes the value of appropriate expedients where cost allocations are not expected to be materially affected. Therefore, the standard provides for the use of a different period for establishing an allocation base when agreed-to by the parties if the:

(1) practice is necessary to obtain significant administrative convenience,

(2) practice is consistently followed by the contractor,

(3) annual period used is representative of the activity of the cost accounting period for which the indirect costs to be allocated are accumulated, and

(4) practice can reasonably be expected to provide a distribution to cost objectives of the cost accounting period not materially different from that which otherwise would be obtained.

e. Contractors shall follow consistent practices in selecting the cost accounting period or periods in which any types of expense and any types of adjustment to expense (including prior period adjustments) are accumulated and allocated.

f. Indirect cost allocation rates, based on estimates, which are used for the purpose of expediting the closing of contracts which are terminated or completed prior to the end of a cost accounting period need not be those finally determined or negotiated for that cost accounting period (see 6-711.1 and 6-711.2). They shall, however, be developed to represent a full cost accounting period, except as provided in c. above.

g. If noncompliances are found, the auditor must ascertain their significance and make the appropriate recommendations as outlined in 8-302.7.

8-406.2 Restructuring Costs **

a. The Cost Accounting Standards Board promulgated an interpretation at CAS 406-61 that addresses the assignment of restructuring costs to accounting periods. According to the interpretation, it clarifies whether restructuring costs are to be treated as an expense of the current period or as a deferred charge that is subsequently amortized over future periods. CAS 406.61, which was issued on June 6, 1997, is applicable to contractor restructuring costs paid or approved on or after August 15, 1994.

b. CAS 406-61(e) provides that restructuring costs should be accounted for as a deferred charge unless the contractor proposes, and the contracting officer agrees, to expense the costs for a specific event in a current accounting period. Deferred restructuring costs should be amortized over the same period of time that benefits of restructuring are expected to accrue. However, CAS 406.61(h) limits the amortization period to no more than 5 years. See Selected Areas of Cost Guidebook, Chapter 63 for further guidance.

8-407 Cost Accounting Standard 407 - Use of Standard Costs for Direct Material and Direct Labor **

a. The purpose of this standard is to provide criteria:

(1) under which standard costs may be used for estimating accumulating, and reporting costs of direct material and direct labor, and

(2) relating to the establishment of standards, accumulation of standard costs,

and accumulation and disposition of variances from standard costs.

The standard was effective October 1, 1974 and must be followed in the next fiscal year after the award of a CAS-covered contract.

b. The standard does not cover standards used for overhead, service centers, nor preestablished measures used solely for estimating.

c. Using the standard for Government contract costing is the contractor's option. Contractors are not required to establish standard cost accounting systems or use established standard cost accounting systems, intended for management purposes, for costing Government work. However, they are required to follow the provisions of the standard if they choose to cost Government contracts through a standard cost accounting system.

8-407.1 General **

Use of a standard cost accounting system to cost Government contracts is permitted only when it meets the following criteria:

a. The standard costs must be entered into the books of account. However, properly computed variances may be allocated by memorandum worksheet adjustments rather than entered in the books of account.

b. The standard costs and related variances must be appropriately accounted for at the level of the production unit. A production unit is defined as "A grouping of activities which either uses homogeneous inputs of direct material and direct labor or yields homogeneous outputs such that the costs or statistics related to these homogeneous inputs or outputs are appropriate as bases for allocating variances". This concept of homogeneity should permit contractors a degree of flexibility in setting and revising standards on the basis of individual needs and circumstances and still provide for the proper cost assignment of variances. Under this concept, a single product manufacturer would be permitted to have one labor variance account for the entire plant, while a multiproduct manufacturer would be required to have a variance account for each product line and/or for the various common part sub-product lines.

c. The practices with respect to the setting and revising of standards, use of standard costs, and disposition of variances must be stated in writing and consistently followed. The written statement of practices shall include bases and criteria used in setting and revising standards; the period during which standards are to remain effective; the level, such as ideal or realistic, at which material-quantity standards and labor-time standards are set; and conditions, such as those expected to prevail at the beginning of a period, which material-price standards and labor-rate standards are designed to reflect.

d. If noncompliances are found, the auditor must ascertain their significance and make the appropriate recommendations as outlined in 8-302.7.

8-407.2 Illustrations **

The following illustrations supplement those in paragraph 407-60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the provisions of the standard.

a. **Problem.** A contractor who manufactures radios of various configurations has established labor-rate standards and variance accounts by department; i.e., fabrication, minor assembly, final assembly, and test. The functions performed within each department are similar, the employees involved are interchangeable, and the inputs of direct material are homogeneous. Each variance account is distributed annually on the basis of the department's labor dollars. The contractor's practices are stated in writing, consistently followed, and the standard costs are entered into the books of account.

Solution. The contractor's practice complies with the standard because it meets the following requirements.

(1) The practices are written, entered into the books, and consistently followed (CAS 407-40(a) and (c)).

(2) The labor-rate standards cover employees performing similar functions within each category, and the employees are interchangeable with respect to the functions performed (CAS 407-50(a)(3)).

(3) Each department qualifies as a production unit because:

(a) each is a grouping of activities which use homogeneous inputs of direct material and direct labor, in this case labor with similar skills and efforts, and

(b) the direct labor costs (homogeneous inputs) are an appropriate basis for allocating variances (CAS 407-30(a)(7)).

NOTE: Since the employees are interchangeable and efforts performed on the radios are similar, the allocation on the basis of direct labor dollars will result in a reasonably valid assignment of the labor rate variances (differences between actual and standard rates) among the radio configurations (units of output).

(4) Standard cost and related variances are appropriately accounted for at the level of the production unit (CAS 407-40(b) and 407-50(c)).

(5) The variances are allocated to cost objectives annually on the basis of labor cost at standard (CAS 407-50(d)(1)).

NOTE: CAS 407-50(a)(2) states, ". . . where only either the labor rate or labor time is set at standard, with the other component stated at actual, the result of the multiplication shall be treated as labor cost at standard”.

b. **Problem.** Another contractor who manufactures the same general types of radios having various configurations has established labor-time standards by

department; i.e., fabrication, assembly, final assembly, and test. The functions performed within each department are not materially disparate except for the fabrication and testing of A and D radio configurations. The functions required for the A and D configurations differ significantly from the others in terms of operations and complexity (complicated circuitry, finer tolerances, more detailed wiring, etc.). The employees involved are interchangeable, and the inputs of direct material are homogeneous. The labor hours required for efforts performed within the departments for each configuration of the radios differ; however, this has been recognized in establishing the standards for each configuration. The labor-time variances (difference between total department standard hours and total department actual hours) are accumulated by department and distributed annually to each configuration within each department on the basis of the department's direct labor dollars (standard labor hours at actual rates). The contractor's practices are stated in writing and consistently followed and standard cost is entered into the books of account.

Solution. The contractor's practice as applicable to the fabrication and testing departments does not comply with the standard. These departments do not qualify as production units because direct labor dollars are not an appropriate base for allocating the labor-time variance to all radios on a pro rata basis since functions performed on the A and D radios are significantly disparate from the functions performed on the other radios. The standard's definition of production unit includes the requirement that, “. . . the costs or statistics relating to these homogeneous inputs or outputs are appropriate as basis for allocating variances" (CAS 407-30(b)(7)). One course of corrective action would be to subdivide the fabrication and testing departments in a manner which would permit separate accounting for the labor cost variances applicable to A and D configurations separate from the other configurations. This correction would result in establishing separate bases and would then be appropriate for allocating the separate variance accounts.

c. **Problem.** In a current proposal, a contractor with a standard cost system prices the bill of materials with quotations rather than with its material price standards. The contractor's written statement of practices, prepared to comply with paragraph 407.50(a)(1), states that material price standards are revised effective 1 January each year and remain in effect until the end of the calendar year. The proposed contract will be performed in the current calendar year.

Solution. The use of quotations to price the bill of materials violates CAS 401. It is inconsistent with the practice of measuring direct material cost by standards and variances. The bill of materials should be priced with the material price standards currently in effect. The amount of material price variances that will be allocated to the contract from production units should be estimated separately. [Note: There could be significant difference between the amount of material cost estimated with quotations and the amount estimated by standards and variances. A difference would result, for example, if quotations are for the quantities required for the proposed contract and standards are based on economic order quantities for all of the contractor's business.]

d. **Problem.** Same as c., with the exception that the proposed contract will be

performed in the next calendar year. Material price standards have not been established for that year.

Solution. The use of quotations would be acceptable provided they are the basis for estimates of next year's material price standards.

8-408 Cost Accounting Standard 408 - Accounting for Costs of Compensated Personal Absence **

The purpose of this standard is to establish criteria for measuring and allocating the costs of compensated personal absences to final cost objectives. These costs include compensation paid by contractors to their employees for such benefits as vacation, sick leave, holiday, military leave, etc. The standard was effective July 1, 1975. It must be followed in the next fiscal year after receiving a CAS-covered contract.

8-408.1 General **

a. The provisions of the standard require that the costs of compensated personal absence be assigned to the cost accounting period in which entitlement is earned in accordance with the contractor's plan or custom. The standard defines compensated personal absence as:

> *"any absence from work for reasons such as illness, vacation, holidays, jury duty, military training, or personal activities, for which an employer pays compensation directly to an employee".*

Additionally it defines entitlement as "an employee's right, whether conditional or unconditional to receive a determinable amount of compensated personal absence, or pay in lieu thereof".

These conditions required many contractors, which had previously recorded such costs when paid, to revise their accounting practices to accrue the costs over the period during which the qualifying service was performed.

b. Entitlement is recognized on the accrual basis only in the cost accounting period in which there arises a liability to pay compensation in the event of layoff or other nondisciplinary termination of employment.

c. The standard supplements these requirements with the following clarifying comments:

(1) If the employer's plan or custom provides that a new employee must complete a probationary period before the employer is liable to pay the employee for compensated personal absence, such service may be treated as creating entitlement, provided the contractor does so consistently.

(2) If the employer's plan or custom provides that entitlement is to be determined on the first calendar day or the first business day of a cost accounting

period, entitlement will be considered earned in the preceding cost accounting period.

d. When there is no liability for payment of unused entitlement on layoff, such costs will be considered to be earned in the period in which paid. In this case, the accrual method is not permitted.

e. Each plan or custom must be evaluated individually to determine when entitlement is earned. If a plan or custom is changed, a new determination of entitlement must also be made. In evaluating each individual plan, the auditor will make use of the contractor's written policies and procedures and any prior examinations included in the FAO permanent files. However, there may be instances, particularly at smaller contractor locations, where written policies and procedures do not exist. In these circumstances, the auditor will evaluate the "custom" of the employer for paying compensation for personal absences.

f. Various contractor sources may provide the needed information for determining entitlement. Examples include personnel records and memoranda, corporate minutes relating to costs of personal absences, financial statements and accounts relating to compensation for personal absence, and the appropriate journal entries supporting the books of account.

g. The liability to be accrued is the total amount the contractor is obligated to pay for each plan in the event of layoff, notwithstanding that the employee may forfeit some or all of the entitlement if she or he were to resign voluntarily. The liability will be adjusted for anticipated nonutilization, if it is expected to be material.

(1) The use of either current wage rates or anticipated wage rates at the time of payment is permitted provided such rates are applied consistently.

(2) The standard also permits the option of calculating the accrued liability either on an individual employee basis or on a total plan basis. A contractor choosing to estimate the total cost of all employees in the plan may use sample data, experience, etc. The auditor should evaluate the data used to assure that the classes and types of employees included are representative of the employee group during the period for which the liability is being accrued.

h. As noted previously, many contractors record costs of personal absences only when paid, but under the standard they will now be required to accrue such costs. Therefore, in the year of conversion, two years' expenses are recorded - the costs paid during the year and the accrual for costs earned during the year but to be paid in a future year. To prevent a double charge to Government contracts, the standard requires contractors to defer the initial accrual through the use of a suspense account. Whenever the balance in the suspense account at the beginning of the cost accounting period exceeds the contractor's corresponding liability for compensated absence at the end of the same cost accounting period, the contractor is permitted to reduce the suspense account until it is equal to the liability. The amount by which the suspense account is so reduced becomes an additional cost of compensated personal absence

for that cost accounting period.

i. There may also be instances where the contractor's practice is to accrue only a portion of the estimated liability required by the standard. In such cases, the contractor must revise its accounting practices to accrue the balance of the liability, as required by the standard. The amount of the additional accrual must be placed in a suspense account, as described above. In such cases, it should also be noted that, in comparing the amount in suspense to the year-end liability, only that part of the liability which corresponds to the suspense account, i.e., the liability for benefits not recognized under the previous accounting practice, should be used.

j. If a plan or custom is changed or a new plan or custom is adopted by the employer, an initial or additional accrual may also be required. This accrual is also to be placed in suspense. The suspense amount to be charged in each cost accounting period will be computed as described above.

k. The costs of personal absence must be allocated among cost objectives on an annualized basis, except as permitted by the provisions of CAS 406 - Cost Accounting Period. However, the allocation rate may be revised during a cost accounting period based on revised estimates of period totals.

l. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-408.2 Illustrations **

The following illustrations are intended to supplement those in paragraph 408-60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the provisions of the standard.

a. **Problem.** A contractor has a program whereby an employee on reaching a certain level within the management structure becomes entitled to a 3-month sabbatical vacation with pay on completion of five years of service. No entitlement to the sabbatical vests in the employee until it is actually taken. If the employee were to be terminated prior to the completion of five years, she or he would not be paid. The contractor becomes subject to CAS 408 and wishes to accrue the cost of the sabbatical vacation ratably over the 5-year eligibility period.

Solution. This contractor may not accrue the cost of the sabbatical vacation since its present policy does not meet the criteria for accrual required by CAS 408-50 (b)(1). Under this provision, entitlement is recognized on the accrual basis in the same cost accounting period in which the employer becomes liable to pay compensation in the event of layoff (vested). However, under this contractor's policy, the employee would not be paid if terminated prior to the completion of 5 years. In this case, the contractor would be subject to the provisions of CAS 408.50(b)(3) which require that when no liability exists for the payment of unused entitlement on layoff, the cost of the compensated personal absence is to be recorded in the cost accounting period in which the leave is taken and/or paid. If the contractor changed its present policy to provide for

a pro rata vesting (that is, payment on a pro rata basis in the event of termination) over the 5-year eligibility period, then the accrual for the sabbatical vacation would be acceptable.

b. **Problem.** The contractor has a vacation plan which provides that an employee who has been employed at least one year at December 31 becomes entitled to 80 hours of vacation, starting no earlier than the following May 1, provided the individual is still employed at that time. If the employee were to be laid off prior to May 1, 1988, he or she would be paid on May 1, 1988 for the vacation earned as of December 31, 1987. If the employee were still in layoff status as of May 1, 1989, she or he would then be paid for any vacation earned between January 1, 1988 and the date of layoff. However, if the employee were to quit voluntarily before May 1, 1988, he or she would forfeit the right to vacation pay. The contractor's fiscal year ends March 31, 1988 under CAS 408 to reflect its liability for vacation pay.

Solution. CAS 408-40(a) requires that the cost of vacation pay be assigned to the cost accounting period or periods in which the entitlement was earned. In this case, vacation was earned during the annual period ending on December 31, 1987. Although retention on the payroll or reemployment status is required to actually receive the vacation at May 1, 1988, the estimated vacation liability amount has already been determined by the preceding December 31. In addition, CAS 408.50(b)(1) establishes the liability to be recognized as that amount of vacation pay which would be payable on layoff, even though some employees may voluntarily terminate and forfeit their entitlement. Therefore, the contractor, in determining its liability at March 31, 1988, should include both the amount earned for service between April 1, 1987 and December 31, 1987, and the amount earned for service between January 1, 1988 and March 31, 1988. This liability should be reduced for anticipated forfeitures, if material, as required by CAS 408.50(c)(2). It should be noted that in the fiscal year ended March 31, 1987, if this was the contractor's initial compliance with the standard, the contractor would have been required under CAS 408.50(d)(1) and (3) to place in suspense the excess of any accrual required by the standard as of March 31, 1987 over the amount it would have accrued under the previous accounting method and amortize such suspense account in accordance with the terms of the standard.

c. **Problem.** The following is an example of how to use the suspense account in a partial accrual situation: Company A has a union agreement which requires it to pay hourly employees for unused vacation on layoff. The company follows a similar custom with salaried employees, although, it is not required to do so by any written agreement. Company A's practice has been to accrue the cost of the vested vacation for the hourly employees but to recognize the cost of salaried vacations only at the time of payment. Company A must comply with CAS 408 beginning on January 1, 1986 and must revise its accounting practice accordingly.

Solution. The total vacation cost determination is shown below in the form illustrated in the standard, followed by the same calculation in columnar form, as follows:

Format Used in CAS 408-60

Period	Hourly Employees ('000)	Salaried Employees ('000)	Total Employees ('000)
1986 beginning liability:			
With standard	$ 500	$ 100	$ 600
Without standard	500		500
Amount to be held in suspense (CAS 408.50(d)(1))	0	100	100
1986 ending liability	400	80	480
Plus paid in 1986	475	95	570
Subtotal	875	175	1,050
Less 1986 beginning liability	500	100	600
1986 vacation cost, basic amount	375	75	450
Amount in suspense at beginning of 1986	0	100	100
Less 1986 ending liability	0	80	80
Suspense to be written off in 1986:			
Additional 1986 vacation cost (CAS 408,50(d)(3))	0	20	20
1986 basic vacation cost	375	75	450
Plus 1986 writeoff of suspense (CAS 408.50(d)(3))	0	20	20
1986 total vacation cost	$ 375	$ 95	$ 470

Columnar Format

	Vacation Liability (000)	Vacation Cost (000)	Cash (000)	Suspense Account (000)	Ref. Note

	Vacation Liability (000)	Vacation Cost (000)	Cash (000)	Suspense Account (000)	Ref. Note
Beginning Liability without standard	$ 500				a
Suspense account	100			$100	b
Beginning liability with standard	600			100	c
1986 earned vacation	450	450			d
1986 vacation pay	570		570		e
Subtotal	$ 480	$ 450	$ 570	$ 100	b
Adjust suspense account		20		20	g
Balances, 12/31/86	$ 480	$ 470	$ 570	$ 80	f

Notes to Columnar Format

(a) Represents the beginning liability amount accrued for the hourly employees under the contractor's previous method.

(b) Represents the setup of the suspense amount for the increase in vacation liability for salaried vacations as required by the standard.

(c) Represents the increase in liability for the total vacation cost earned by employees during the cost accounting period.

(d) Represents the reduction in liability for the amount paid to employees during the cost accounting period.

(e) Represents the ending liability amount for the cost accounting period as well as other account balances resulting from the transactions discussed above. The total ending liability of $480 thousand is composed of $400 thousand for hourly vacations and $80 thousand for salaried vacations.

(f) The amount in suspense ($100 thousand as discussed in b. above) should be compared with that portion of the vacation liability at the end of the year, which represents the same type of expense charged to suspense account ($80 thousand for salaried vacations as discussed in f. above). As the amount in suspense exceeds the ending liability, the excess ($20 thousand) will be charged to the vacation cost earned during the year and the suspense account balance will be reduced by the amount of the

excess.

This illustration presented one acceptable method for comparing the amount in suspense with the liability at the end of the year. Other methods, such as specific employee identification, may also provide a reasonable satisfaction of the standard's requirements. The method used should achieve a comparison of like items for authorization of the amount held in suspense.

d. **Problem.** A contractor has a fiscal year ending December 31. Under this existing practice, the contractor begins to accrue for each holiday one year in advance. For example, the anticipated cost of holiday pay for July 4, 1987 would be accrued in 12 monthly increments beginning July 1986 and extending through June 1987. However, under the contractor's policy, entitlement for holiday pay occurs only in the cost accounting period when the holiday is taken.

Solution. The contractor's practice does not comply with CAS 408. CAS 408.40(a) requires that holiday pay be assigned to the cost accounting period in which it is earned. Under the contractor's policy, entitlement occurs when the holiday is taken. Therefore, the contractor may recognize in 1986 only the costs of holidays that occurred in 1986. It should be noted that a contractor whose fiscal year ends on December 31 may elect to recognize the costs of the January 1 holiday either in the year in which it occurs or in the preceding year, provided whichever policy is adopted, it is followed consistently.

8-409 Cost Accounting Standard 409 - Depreciation of Tangible Capital Assets **

a. This standard provides criteria for assigning costs of tangible capital assets to cost accounting periods and should enhance objectivity and consistency in their allocation.

b. The initial standard was effective July 1, 1975 and must be followed for all tangible assets acquired in the next fiscal year after receipt of a CAS-covered contract. On February 13, 1996, the CAS Board amended CAS 409-50(j) relating to the recapture of gains and losses on disposition of tangible capital assets that are transferred subsequent to a business combination. The effective date of this amendment is April 15, 1996. The amendment is applicable to contracts in the next cost accounting period beginning after receipt of a contract that incorporates the revised standard. Amendments to CAS 404, also effective April 15, 1996, are discussed in 8-404.

c. The amended CAS 409, effective April 15, 1996, applies to tangible capital assets transferred in a business combination that takes place after the applicability date (see 8-404.4 for illustrations of the amended CAS 404 and 409 applicability date).

d. The standard does not apply where compensation for tangible capital asset usage is based on use allowances as provided in Office of Management and Budget Circulars A-21 and A-87, and 2 CFR Part 200, or other appropriate acquisition regulations.

8-409.1 General **

a. Estimated residual values must be determined for all tangible capital assets or groups of assets. The residual values must be deducted from the capitalized value in computing the depreciable cost base, except where; (1) the estimated residual value of tangible personal property does not exceed 10 percent of the capitalized cost or (2) either the declining balance method or class-life-asset-range system is used.

b. The standard prohibits the depreciation of assets or asset groups below their residual value, if the residual value is greater than ten percent of the capitalized cost of the asset, or if the asset is real property. For personal property that has a residual value less than or equal to ten percent of the capitalized cost of the asset, the asset or asset group may be depreciated below residual value if the residual value is immaterial. Materiality should be determined based on the general criteria contained in 48 CFR 9903.305, Materiality. The auditor should test asset values identified on contractor depreciation schedules or tax returns to ensure that residual values are properly deducted from capitalized costs.

c. The estimated service life of the tangible capital asset, over which the depreciated cost is assigned, must reasonably approximate the actual period of usefulness to its current owner, considering such factors as obsolescence and required quality and quantity of output. The estimated service life can exclude standby or incidental use periods, provided adequate records substantiate the withdrawal of such assets from active use. Expected periods of useful life must be based on recorded past experience, as modified for expected changes in operating practices, obsolescence, or quantity of products produced. However, the contractor must justify estimated service lives which deviate from the previously experienced lives. (See CAS Working Group Paper 78-22.)

(1) The standard requires the contractor to maintain adequate records which identify the age of the asset or asset group at retirement or withdrawal from active use. The record should contain such information as asset acquisition/disposition dates, date asset was withdrawn from active service, and any other factors that directly influence asset lives. The record need not be maintained solely for fixed asset accounting; it may be a record used for such other purposes as property insurance, income/property taxes, property control, or maintenance.

(2) If supporting records are not available on the date the contractor must first comply with the standard, the estimated service lives should be those used for financial accounting. However, the required supporting records must be developed by the end of the second fiscal year after that date and used as a basis for estimated service lives on assets subsequently acquired.

(3) When a new asset is acquired for which the contractor has no available data or prior experience, the estimated service life must be based on projection of the expected useful life. CAS 409-50(e)(4) states the projection cannot be less than the mid-range established for asset guideline classes under the IRS Revenue Procedures in effect the year the asset is acquired. For property placed in service after 1986, IRS

Revenue Procedure 87-56, as modified by Revenue Procedure 88-22, does not provide a depreciation range for asset guideline classes, it provides the applicable class lives and specific recovery periods. The recovery period used will depend on the depreciation system (General Depreciation System (GDS) or Alternate Depreciation System (ADS)) selected. The depreciation method (e.g., declining balance or straight line) selected by the contractor will determine the depreciation system used and the resulting recovery period. Information in IRS Revenue Procedure 87-56, as modified by Revenue Procedure 88-22 is available in IRS Publication 946, How to Depreciate Property. IRS Publication 946 will identify the depreciation method(s) that may be used for each depreciation system. For example, declining balance method can only be used over a GDS recovery period, while the straight line method may be used over a GDS or ADS recovery period. The estimated service lives provided in these IRS documents will be used only until the required records are available. All IRS publications can be found on the IRS website.

(4) In special circumstances, contracting parties may negotiate a shorter estimated service life if it can be reasonably projected.

d. The contractor may select any appropriate method of depreciation which reflects the pattern of consumption of services over the life of the asset. For example, an accelerated method is appropriate where the expected consumption of services is greatest in the early years of the asset life. The method used for financial accounting must be used for contract costing unless it does not reasonably reflect expected consumption or is unacceptable for Federal income tax purposes.

(1) Financial accounting methods are expected to approximate the pattern of consumption of services. Therefore, if the contractor continues to use previous methods found to be acceptable to the Government on similar assets for financial accounting, no additional support of existing method will ordinarily be required. The auditor, however, is responsible for ensuring that the depreciation methods generally reflect the pattern of consumption of services. Consequently, the auditor's compliance audit should include limited tests of existing usage records to determine that no gross distortions in depreciation costs result from these depreciation methods. If a gross distortion is indicated as a result of that limited test, the testing should be expanded to determine whether the distortion is material enough to warrant a change in the contractor's depreciation method.

(2) A depreciation method selected for newly acquired assets, which differs from the depreciation method currently used for like assets in similar circumstances, must be supported by the contractor's projection of expected consumption of services.

e. Depreciation costs are generally allocated as indirect costs to the cost objectives for which the assets provide service. They may be charged directly to cost objectives at average rates only if the charges are based on usage and the costs of all like assets used for similar purposes are also charged directly. Depreciation costs for assets included in service centers, where significant, must be charged to the service center.

f. Changes to estimated service lives, residual values, or consumption of services may be required as a result of significantly changed circumstances. Any resulting adjustment to the undepreciated cost will be assigned only to the cost accounting period in which the change occurs and to subsequent periods. No retroactive adjustments will be made.

g. The standard outlines the following accounting treatment for gains or losses associated with the disposition of tangible capital assets. Note that an impairment loss under FASB Statement No. 144 is recognized only upon disposal of the impaired asset (see Selected Areas of Cost Guidebook, Chapter 19).

(1) Where the asset is disposed of without an exchange, the gain or loss is generally treated as an adjustment to the appropriate indirect expense pool in the cost accounting period in which the disposition occurs. However, the auditor should be aware that, in such circumstances, the standard limits the gain to be recognized for contract costing purposes to the difference between the asset's original acquisition cost and its net book value.

(2) Where an asset is exchanged for like property, two options are available to the contractor: either the gain or loss can be recognized as discussed above, or the depreciable cost base of the new asset may be adjusted for the entire gain or loss.

(3) Where an asset disposition results from an involuntary conversion and the asset is replaced by a similar asset, the same two options as described above for exchanges of like property are available to the contractor.

(4) Where assets are grouped, gains or losses are not recognized. Instead they are processed through the accumulated depreciation account.

(5) Assets dispositioned in a business combination meeting the criteria in CAS 404-50(d)(1). The revised CAS 409, effective April 15, 1996, added a new subparagraph CAS 409-50(j)(5) to make it clear that the CAS 409-50(j) provision dealing with the recapture of gains and losses on disposition of tangible capital assets should not apply when assets are transferred subsequent to a business combination meeting the criteria in CAS 404-50(d)(1). The revised CAS 409-50(j)(5) stipulates that the provisions of CAS 409.50(j) do not apply to business combinations and that the carrying values of tangible capital assets acquired subsequent to a business combination are to be established by the acquiring company in accordance with the provisions of CAS 404-50(d)(1). Consequently, since CAS 404-50(d)(1) does not recognize an increase or decrease in the asset values as a result of a business combination, any gain or loss realized by the seller on disposition of assets as a result of the business combination is also not recognized. Auditors at the seller location should be alert for contractors claiming a loss on disposition of assets as a result of a business combination meeting the provisions of CAS 404-50(d)(1) and if claimed and determined significant, issue a CAS noncompliance report. See 8-404.2(b)(1) for additional guidance regarding the measurement of assets acquired in a business combination using the purchase method of accounting.

(6) Assets dispositioned in a business combination meeting the criteria in CAS 404-50(d)(2). The April 15, 1996 revision to CAS 409-50(j)(5) does not apply to assets dispositioned in a business combination meeting the criteria in CAS 404-50(d)(2), i.e., the tangible capital assets acquired in the business combination did not generate either depreciation expense or cost of money charges during the most recent cost accounting period. Therefore, the provision on the recapture of gains and losses would apply to the dispositioned assets. However, for contracts awarded prior to April 24, 1998, tangible capital assets meeting the requirements of CAS 404-50(d)(2) must still comply with the requirements of FAR 31.205-16 and 31.205-52. Consequently, although the gain or loss may be recognized for CAS purposes, no gain or loss would be allowed per FAR. FAR 31.205-52 was revised effective April 24, 1998 (FAC 97-04), to conform to the revised CAS 404 and 409. Therefore, a gain or loss would be allowed for assets dispositioned in a business combination meeting the criteria in CAS 404-50 (d)(2).

h. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-409.2 Illustrations **

The following illustrations supplement those in paragraph 409-60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the standard.

a. **Problem.** Based on a sample of asset dispositions/withdrawals for the last three years, the contractor now estimates 10 years for the service life for lathes. The records in the sample supporting the 10-year life classified several machines as "withdrawn from active use" although the machines are still on hand, in good working condition, and physically located in the plant machine shop. Neither the property records nor any other records reflected any change in the assets from active to inactive status. Records reflect a comparatively low usage of these specific machines for the past year due to a slack period.

Solution. The machines should not be classified as "Withdrawn from active use" unless the contractor provides adequate documentation substantiating the change in status. Machines temporarily idled for lack of work are not "withdrawn from active service". The contractor's written policies and procedures should define (1) the conditions under which capital assets may be withdrawn from active use and (2) the property records that must be prepared for processing the asset from active to inactive status. The records should clearly support that assets "withdrawn from active service" are in actuality intended only for standby or incidental use.

b. **Problem.** Contractor purchases various tangible capital assets in FY 20XX and sells them seven years later. Information pertinent to the acquisition and sale is as follows:

Capital Equipment	Acquisition Cost	Capitalized Current Net	Sales Price

		Book Value	
Lathe	$30,000	$10,000	$32,000
Truck	$5,000	$ -0-	$ 100
Fork Lift	$10,000	$3,000	$2,000

Depreciation expense over the seven years was allocated to manufacturing overhead.

Solution. The contractor will allocate gains and losses to manufacturing overhead in the year of sale as follows:

Capital Equipment	(Gain)* or Loss
Lathe	($20,000)
Truck	($100)
Fork Lift	$1,000

*Gain or loss is the difference between amount realized on disposition and its undepreciated balance ($32,000 - $10,000 = $22,000); however, per CAS 409.50(j)(l), for contract costing purposes, the gain must be limited to the difference between the original acquisition cost of the asset and its undepreciated balance ($30,000 - $10,000 = $20,000).

c. **Problem.** The capitalized cost of a lathe is $50,000. The lathe is projected to have a residual value of $4,500, which is determined to be immaterial in amount based on the criteria in 48 CFR 9903.305, and an estimated service life of 10 years. The contractor utilizes a straight-line depreciation method. The asset is sold in Year 11 for $5,000.

Solution. Because the $4,500 residual value is less than 10 percent of the capitalized cost, the annual depreciation charges may be based on a depreciable cost base of $50,000. In addition, since the $4,500 is immaterial, the asset is depreciated to zero. However, since the contractor is required to provide a credit for the difference between the sales price and the book value, a credit of $5,000 is recognized in Year 11, as shown below:

Depreciable cost base	$50,000
Accumulated depreciation: 10 years @ $5,000 per year	$50,000

Net book value at end of 10th year	$ -0-
Year 11: Credit for Gain on Sale of Asset (Sales price of $5,000 less book value of zero)	$ 5,000

d. **Problem.** Contractor A acquires Contractor B and accounts for the business combination using the purchase method of accounting. Prior to the business combination, the net book value of Contractor B's assets was $10.5 million. Contractor B's assets generated depreciation expense and cost of money charges that were allocated to Government contracts negotiated on the basis of cost in its most recent cost accounting period. The difference between the original acquisition cost of Contractor B's assets and its undepreciated balance is $3.0 million. For GAAP purposes, the difference between the sales price and net book value of assets results in a gain of $4.0 million. The revised CAS 409 applies to the business combination.

Solution. The provisions of the amended CAS 404-50(d)(1), effective April 15, 1996, would apply to the business combination because the seller's (Contractor B's) assets generated depreciation or cost of money charges that were allocated to Government contracts negotiated on the basis of cost in its most recent cost accounting period. Therefore, the provisions of CAS 409-50(j) dealing with the recapture of gains and losses on disposition of capital assets would not apply to the business combination. For CAS purposes, Contractor B would not recognize the gain. Consequently, the gain would not be reflected in Contractor B's total cost input G&A base because the gain was not measured for CAS purposes.

e. **Problem.** Same facts as Problem d. above, except that Contractor B has not performed Government contracts for several years and consequently, its assets did not generate depreciation expense or cost of money changes that were allocated Government contracts negotiated on the basis of cost, in its most recent cost accounting period.

Solution. The provisions of the amended CAS 404-50(d)(2), effective April 15, 1996, would apply to the business combination because the seller's (Contractor B's) assets did not generate depreciation expense or cost of money charges on Government contracts in its most recent cost accounting period. Therefore, the provisions of CAS 409-50(j) dealing with the recapture of gains and losses on disposition of capital assets would apply to the business combination. For CAS purposes, Contractor B would recognize the $3.0 million difference between the original acquisition cost and the undepreciated balance and credit the appropriate indirect cost pool(s). For contracts awarded prior to April 24, 1998, the gain would not be recognized under FAR 31.205-16 and 31.205-52. However, for contracts awarded on or after April 24, 1998, the gain would be recognized.

8-410 Cost Accounting Standard 410 - Allocation of Business Unit General and Administrative Expenses to Final Cost Objectives **

a. This standard provides criteria for the allocation of general and administrative (G&A) expenses to final cost objectives and furnishes guidelines for the type of expense that should be included in the G&A expense pool. It also establishes that G&A expense shall be allocated on a cost input base that represents total activity. Contractors presently using the sales or cost of sales allocation base have the option of changing to the cost input allocation base as soon as they become subject to the standard or selecting the special transition method described in Appendix A of the standard. Notably, the special transition method permits the continued use of the sales or cost of sales base to cost those CAS-covered contracts existing on the date the contractor is required to comply with this standard. The standard will increase the likelihood of achieving objectivity in the allocation of expenses to final cost objectives and comparability of cost data among contractors in similar circumstances.

b. The standard was effective October 1, 1976 and must be followed in the next fiscal year after receipt of a CAS-covered contract to which the standard is applicable.

c. See CAS Working Group Papers 78-21 and 79-24 for guidance issued by the CAS Working Group on CAS 410.

8-410.1 General **

a. Business Unit G&A Expense Pool

(1) The G&A expenses must be grouped in a separate indirect cost pool and allocated only to final cost objectives. For an expense to be classified as G&A, it must be incurred for managing and administering the whole business unit. Therefore, those management expenses that can be more directly measured by a base other than cost input should be removed from the G&A expense pool. For example, expenses such as program management, procurement, subcontract administration, G&A-type expenses incurred for another segment, etc. should not be identified as G&A expenses. They should be the subject of a separate distribution in reasonable proportion to the benefits received. However, immaterial expenses which are not G&A may be included in the G&A expense pool. The G&A expense pool may be combined with other expenses allocated to final cost objectives if (a) the base for the combined pool is appropriate for allocating both the G&A expense pool and the other expenses, and (b) the individual and total expenses of the G&A expense pool can be identified separately from the other expenses.

(2) FAR 31.203(d) requires G&A expenses be allocated to final cost objectives through a base that contains unallowable costs. FAR 31.203(d) states that "all items properly includable in an indirect cost base should bear a pro rata share of indirect costs irrespective of their acceptance as Government contract costs". The CASB has also recognized this principle in the prefatory comments to CAS 405 (last paragraph of comment no. 4) stating "the allowance or disallowance of these costs is subject to the cognizant agency's cost principles". In ASBCA Case No. 35895, Martin Marietta Corp. challenged the Government's position that a portion of G&A expense allocated to contracts is unallowable in the same ratio as unallowable base costs are to total base costs allocated to a contract. The issue was resolved on December 28, 1993

by the U.S. Court of Appeals for the Federal Circuit (No. 93-1025). The Court upheld the Government position, stating that FAR 31.203(d) is primarily an allowability provision which does not conflict with the CAS 410 requirement that G&A be allocated only to final cost objectives.

(3) Selling costs may be accounted for in the G&A expense pool or in a separate pool. CAS 410 takes a permissive position. CAS 410-40(d) requires a separate allocation of costs if the costs can be allocated to business unit cost objectives on a beneficial or causal relationship that is best measured by a base other than a cost input base. Therefore, if the inclusion of selling costs in the G&A pool results in an inequitable allocation, auditors should carefully evaluate the selling activities to determine whether selling costs should be separately allocated on a beneficial or causal relationship by a different base. The Court in Aydin Corporation (West) (U.S. Court of Appeals for the Federal Circuit, No. 94-1441, dated August 10, 1995) decided, reversing the ASBCA decision (ASBCA No. 42760, dated April 18, 1994) that the foreign sales commission need not be excluded from the G&A pool based solely on its disproportionately large dollar amount. Accordingly, although the disproportionate allocation to Government contracts may be an indication that the G&A base is not the best measure of the beneficial or causal relationship, the disproportionate allocation itself does not result in a noncompliance with CAS 410. If it is determined that selling costs should be allocated over a base other than the G&A base, CAS 418 governs the proper allocation of such costs. See Selected Areas of Cost Guidebook, Chapter 65 for additional discussion on the allocability of selling costs.

(4) Home office expenses allocated to a segment may or may not be included in the segment's G&A expense pool. The standard states that allocations of line management expenses, residual expenses, and directly allocated expenses related to managing and administering the receiving segments are to be included in the G&A expense pool. Separate allocations of home office centralized service functions, staff management of specific activities of segments, and significant central payments or accruals must be allocated to the benefiting cost objective. However, when there is no discernible causal or beneficial relationship with any of the cost objectives, these expenses may be included in the segment's G&A expense pool. When separate allocations are reflected in home office cost accounting, they must be identified in the cost transfers to the segments under CAS 403. To support that home office expenses were allocated to the segment in compliance with CAS 403, the contractor must identify the allocation base and components of the expense pool. Segments that perform both home office and operating segment functions must segregate the expenses of the home office function. These expenses must be allocated to the benefiting segments, including the segment performing the home office function. G&A expenses incurred by a segment for another segment will be removed from the incurring segment's G&A expense pool and transferred to the other segment.

(5) Any other costs that do not satisfy the definition of G&A expenses may be included in the G&A expense pool if they were previously a part of G&A and cannot be allocated to final cost objectives on a beneficial or causal relationship best measured by a base other than a cost input base.

b. Business Unit G&A Allocation Base

(1) The standard requires that the cost input base used to allocate the G&A expense pool include all significant elements of that cost input which represent the total activity of the business unit. The cost input base selected may be total cost input, value-added cost input, or single-element cost input. Modified bases are not permitted unless the item is an insignificant element of the selected cost input base and its exclusion does not invalidate the chosen base's representation of total activity. The “insignificant element” should not be automatically equated to insignificant amounts. An insignificant element is one that, when excluded from the base, does not alter the base’s representation of the total activity. In the prefatory comments the term "total activity" refers to the production of goods and services during a cost accounting period. What is being pursued for the base is a flow of costs bearing a reasonable relationship with the production of goods and services.

(a) While the standard says that, "A total cost input base is generally acceptable as an appropriate measure of total activity of a business unit," other bases may be used when they best represent "the total activity" of the business unit. The selection of the best base involves judgments on whether inclusion of certain base costs cause "distortions" in allocating G&A to some contracts. The specific circumstances of the business unit shall be considered in determining which base best represents total activity. The ASBCA, in essence, ruled that there is no preferred allocation base to distribute G&A expenses other than the one which best represents total activity (Ford Aerospace and Communications Corporation, Aeronutronic Division, ASBCA Case No. 23833). The following are some examples where the value-added or single-element base may be appropriate:

- Large subcontracts of the type that clearly contrast with arrangements which require close supervision and participation on the part of the prime contractor, for example, drop shipments. These subcontracts generally do not bear the same relationship to G&A as other cost elements. The existence of these types of contracts as a stable part of the business may be evidence that total cost input may not be an appropriate measure of total activity as it may cause an inequitable amount of G&A to be allocated to the contract with the large subcontracts. Consideration should be given to changing to a value-added base.

- Large amounts of Government-furnished material on some contracts with the same type of material purchased on other contracts. This may cause an inequitable shift of G&A to the contract with purchased materials. Consideration should be given to changing to a value-added base.

- Contractors whose business activity is clearly labor intensive, but have contracts that include major purchasing and subcontracting responsibility on a "pass-through" basis which causes significant

distortions in allocated G&A. Consideration should be given to a value-added or single element base.

- When a contractor has demonstrated by a detailed analysis of the G&A pool elements to individual base elements, that a certain base element does not have significant causal or beneficial relationships to that G&A expense. When this is found, an analysis must be done to decide which of the three bases best measures total activity of that business unit. One perfect base may not exist. Purifying the G&A expense pool is the best way to minimize any potential inequities which may surface in implementing a cost input base which does not perfectly eliminate distortions.

(b) Interdivisional transfers may be excluded from the receiving division's G&A base only when:

- circumstances warrant the use of a base whose constituent parts do not include material such as a value-added or a single-element base, or

- the interdivisional receipts are not significant. Facilities contracts as defined in FAR 45.301 should also be included in the total cost input base unless the provisions of CAS 410-50(j) apply.

(c) The costs deducted from total costs to determine the value-added base should be limited to direct material and subcontract costs. FAR 15.408, Table 15-2, II, Cost Elements, under the heading of Materials, states "Include raw materials, parts, components, assemblies, and services to be produced or performed by others". FAR 44.101 provides an authoritative definition of subcontract costs, which states 'Subcontract,' as used in this part, means any contract as defined in Subpart 2.1 entered into by a subcontractor to furnish supplies or services for performance of a prime contract or a subcontract. It includes but is not limited to purchase orders, and changes and modifications to purchase orders". In applying this definition take care to avoid inappropriate inclusions or exclusions from the value-added base resulting from broad application of terminology or individual contractor account classifications. For example, subcontract labor of the "body shop" type often supplements the normal work force and is used interchangeably with the regular employees under the same supervisors. This work does not fit the definition of services to be performed by other than the contractor. Thus, it would be inappropriate to deduct these amounts from the total costs. On the other hand, it would be appropriate to deduct the cost of subcontracts for items such as interior decoration of aircraft even though a contractor accounts for them as part of other direct costs.

(d) The criteria for use of a single-element cost input base are very specific. A single-element cost input base may be used when a contractor can demonstrate that it best represents the total activity of a business unit and produces equitable results. Thus, a single-element base, such as direct labor dollars, may be

used when the direct labor dollars are significant and the other measures of activity are less significant related to total activity. The contractor should periodically analyze the single-element base to assure that it best represents total activity and produces equitable results. When other measures of activity become significant, a single-element base may not produce equitable results. A single-element base is inappropriate when it is an insignificant part of the total cost of some of the final cost objectives.

(2) Initial changes from one type of input base to another which are required to comply with the standard would be subject to equitable adjustment. For example, a contractor previously used a direct labor hour base for allocating G&A expense. On the applicability date of CAS 410, the contractor changes its G&A allocation base to total cost input because other measures of activity besides direct labor are significant in relation to total activity. Since the base change is required in order to comply with section 410-50(d), the contractor is entitled to an equitable adjustment. Once a G&A base has been selected, it should not be changed unless the underlying business activity changes. When a base change is elected, adequate notice must be given to the CFAO.

(3) A special allocation of G&A expenses is permitted if a particular final cost objective (e.g., contract) would receive a disproportionate allocation of G&A expenses by using the cost input base. However, the allocation from the G&A expense pool to the particular final cost objective must be commensurate with the benefits received. The amount of the special allocation must also be removed from the existing G&A expense pool and the particular final cost objective’s base costs must be removed from the base used to allocate the G&A pool. The 410-50(j) provision is applicable to a particular final cost objective which is an exception to the contractor's normal operation, rather than to classes of contracts or final cost objectives. It appears that the intent is to use the special allocation provision in exceptional cases to resolve situations where equitable allocation cannot be achieved by normal methods. The use of a special allocation to a particular contract or other final cost objective is the only alternative to the uniform allocation requirements of the standard. The standard does not permit the use of an abated or reduced rate for certain costs (e.g., a lesser rate for subcontract costs). Before approving a special allocation, the G&A expense pool should be carefully evaluated to purify it of any expenses that may be allocated to cost objectives more directly than by a cost input base. When a special allocation under CAS 410.50(j) is used, it must be described in the contractor's Disclosure Statement. Otherwise, the contractor would be in noncompliance for failure to follow its disclosed practices.

(4) The standard provides that work on stock or product inventory items represents part of the productive activity of the business unit for a cost accounting period, and therefore should receive an allocation of G&A expense. The costs of such items must be included in the G&A allocation base for the period in which the items are produced or worked on rather than the period in which they are issued to final cost objectives. The cost must be included only once in computing the allocation base and rate. The time these items are issued from inventory to final cost objective is irrelevant for computing the G&A base and for calculating the G&A expense rate.

(a) Where it was the previous practice of the business unit to include G&A expense as part of the product inventory, the cost of all units produced in a period should include the G&A expenses of the cost accounting period in which the items are produced, including those remaining in inventory at the end of the year. Since G&A has already been applied to items in inventory, no additional G&A will be applied when those items are issued.

(b) If the previous practice was not to include G&A expense as part of the cost of product inventory, the business unit must consistently use one of two methods to cost G&A expenses to the cost of product inventory. The first method permits the business unit to allocate G&A to the costs of items produced for stock, including those remaining in inventory at the end of the period, using the G&A rate of the period the items were worked on. This is the same method as allowed for business units that costed G&A expense as part of the costs of product inventory. The second method permits a business unit to allocate G&A to such costs using the rate of the period the items were issued. For example, if a business unit produces 100 items for stock and issues 50 items in period 1 and 50 items in period 2, the cost of 100 items produced would be included in the allocation base of period 1. No costs for these items would be included in the allocation base of period 2. However, for purposes of allocating G&A expense to the inventory, the G&A rate of period 1 would be applied to the 50 items issued in that period, and the G&A rate of period 2 would be applied to the 50 items issued during that period. The CASB believed that the differences in the G&A rates applied to the final cost objectives by using the G&A rate of the year the items are issued rather than produced will not be material.

(c) The auditor should note that the standard only covers the treatment of items produced for stock after the applicability date. It does not cover the treatment of items held in inventory on the first date the contractor must apply the standard. Therefore, items produced for stock and included in inventory on the date the standard becomes applicable should be included in the G&A allocation base of the period in which the items are assigned to final cost objectives.

(5) Questions have been raised as to the relationship between CAS 410 and the methods used by contractors with parts cost accounting systems to transfer Work-in-Process (WIP) to cost of sales. CAS 410 addresses the application of G&A expense to WIP cost input but does not prescribe the cost methods for relieving WIP and charging cost of sales. To comply with CAS 410, a contractor with a parts cost accounting system must compute a fiscal year cost input G&A expense rate to allocate G&A expenses to WIP cost input. However, the contractor may use any inventory valuation method recognized under generally accepted accounting principles, such as FIFO or average, to transfer costs including G&A expense from WIP to cost of sales.

c. If noncompliances are found regarding either the G&A expense pool or the allocation base, the auditor should ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-410.2 Illustrations **

The following illustrations supplement those in paragraph 410.60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the standard.

a. **Problem.** Division X excludes from its total cost input base, the cost of intercompany transfers from Division Y.

Solution. The intent of the standard is that all actions, which represent the total productive activity of the segment, should be included in total cost input. The costs of the intercompany transfers should therefore be included in the total cost input base used to allocate G&A expenses. Division X's exclusion of the intracompany transfers from the base does not comply with the standard.

b. **Problem.** Division X uses a total cost input base. In making its product there is extensive amount of costs for ODC, material, subcontracts, consultants, and special tooling. As these costs are all represented in approximate proportions on all of Division X's contracts, total cost input has been considered the best measure of the division's total business activity. The contractor is now contemplating entering a new business area. New contracts are planned to be bid in 20X2 and may have up to 60 percent of their value in subcontracting of the type that clearly contrasts with arrangements which require close supervision and participation on the part of the prime contractor, for example, drop shipments. Because of the dollar value of these contracts ($50 million) and anticipated follow-on effort compared to Division X's normal contracts ($150 million), the G&A allocated to the new contracts on a total cost input base would far exceed the beneficial relationships to these contracts. Division X notifies the CFAO and the auditor at the beginning of 20X1 that they intend to change their base to value-added. They subsequently change their Disclosure Statement to show the prospective G&A allocation base.

Solution. Division X's criteria for base selection complies with that contained in CAS 410, and the choice of the value-added base complies with the standard. However, this example is only hypothetical. Auditors must exercise professional judgment in assessing each situation individually. No two circumstances are the same.

c. **Problem.** Contractor Z has a number of contracts with large amounts of subcontract costs. The contractor does not believe that the use of the regular G&A rate for the subcontract costs is equitable because the subcontracts do not benefit from all of the G&A pool costs in the same relationship as the other base costs. It is therefore proposing a reduced G&A rate for the subcontract costs.

Solution. The contractor's proposal of a reduced G&A rate for the subcontract costs is in noncompliance with the standard. The only alternative to the uniform allocation requirements of the standard is the special allocation procedures which pertain to particular contracts or other final cost objectives. Special allocations to classes of contracts or to specific cost elements or types of expenses are not permitted by the standard.

8-411 Cost Accounting Standard 411 - Accounting for Acquisition Costs of Material **

a. This standard provides criteria for the accounting of acquisition costs of material, provides guidance on using inventory costing methods, and improves the measurement and assignment of costs to cost objectives.

b. This standard does not cover accounting for the acquisition costs of tangible capital assets or accountability for Government-furnished materials.

c. The standard was effective January 1, 1976, and must be applied to all materials purchased or produced in the next fiscal year after receipt of the CAS-covered contract to which the standard is applicable.

8-411.1 General **

a. The standard requires contractors to accumulate the cost of material and allocate it to cost objectives according to written statements of accounting policies and practices.

b. The end use of a category of material must be identified at the time of purchase or production if the cost is to be allocated directly to a cost objective. A category of material may be allocated directly even though the company maintains an inventory of this material, as long as the cost objective was specifically identified and the cost allocated at the time of purchase or production. Thus, units of a category of material could be allocated at different costs to the same cost objective, which is by direct allocation and issuance from inventory. The auditor should assure that the contractor's written statements of accounting policies and practices for accumulating and allocating costs of materials clearly set out (1) the specific conditions under which these costs may be directly allocated to cost objectives and (2) the inventory costing method to be used for allocating material costs issued from inventory. During regular audits of material, following the procedures in 5-710.1, these written statements will enable the auditor to determine that the contractor's practices comply with the standard and that deviations from the standard (which may arise as a result of contractor actions) are reported.

c. Materials used solely in performing indirect functions or which are not a significant element of production cost may be allocated to an indirect cost pool. However, when the ending inventory significantly exceeds the beginning inventory of such material in an indirect cost pool in relating to the total cost included in the indirect cost pool, the pool should be credited for the unused portion and an asset account established for a like amount. The standard does not require the contractor to take a physical count of the ending inventories for these indirect materials. However, in the absence of a physical inventory, the auditor should make certain that a reasonable method for estimating the cost of unconsumed indirect materials at year-end has been used.

d. All materials, except those directly allocated to final cost objectives (CAS

411-40(b)) and those allocated to an indirect cost pool (CAS 411-40(c)), must be accounted for in material inventory records. "Material inventory record" means any record for accumulating the cost of material for issue to one or more cost objectives. Such records need not be general or subsidiary ledger accounts but may be card files, computer data, bin tags, or any other such informal record. The written statement of accounting policies and practices should describe a material inventory record and explain how it is used.

e. When issuing material from a company-owned inventory, any of the following inventory costing methods are acceptable, provided the same costing method is consistently used for similar categories of material within the same business unit:

(1) The first-in, first-out (FIFO) method.

(2) The moving average cost method.

(3) The weighted average cost method.

(4) The standard cost method.

(5) The last-in, first-out (LIFO) method.

f. Material cost is the acquisition cost of a category of material. The purchase price must be adjusted by extra charges incurred or discounts and credits earned. These adjustments must be charged or credited to the same cost objective as the material price; when this is not practical, charges or credits may be included in an appropriate indirect cost pool, provided this practice is consistent.

g. If noncompliances are found, the auditor must ascertain their significance and make the appropriate recommendations as outlined in 8-302.7.

8-411.2 Illustration **

The following illustration is intended to supplement those in paragraph 411-60 of the standard. It should assist as a guide in determining whether a contractor's practices comply with the standard.

Problem. A contractor's written statements of accounting policies and practices provide that the cost of a category of material used solely in performing an indirect function will be allocated to an indirect cost pool when the material is received. The contractor does not estimate the cost of unconsumed indirect materials at year-end, nor does it compare this ending inventory cost with the cost of the beginning inventory of indirect materials to determine if the excess is significant in relation to the total cost included in the indirect cost pool. All costs of indirect material allocated to the indirect cost pool during the cost accounting period remain in the indirect cost pool at year-end.

Solution. The practice does not comply with CAS 411-40(c). The contractor must determine the significance of the excess of the ending inventory over the

beginning inventory of such materials in relation to the total cost included in the indirect cost pool. If significant, the indirect expense pool must be credited and an asset account established in a corresponding amount.

8-412 Cost Accounting Standard 412 - Composition and Measurement of Pension Costs **

a. This standard establishes the composition of pension costs, the basis of measurement, and the criteria for assigning pension costs to cost accounting periods. CAS 413 addresses the accounting treatment of actuarial gains and losses and the allocation of pension costs to segments of an organization.

b. The standard is basically compatible with the Employee Retirement Income Security Act of 1974 (ERISA), although some of its provisions may be more restrictive than ERISA funding requirements. The fundamental objectives of CAS 412 differ from the objectives of ERISA. ERISA is primarily a funding law; it is designed to ensure financial integrity of pension plans through minimum funding standards. CAS 412 was promulgated to ensure that pension costs are properly measured and allocated to cost objectives.

c. CAS 412 was effective January 1, 1976 and must be followed in the next fiscal year after receiving a CAS-covered contract to which the standard is applicable. This standard was revised effective March 30, 1995. The revisions are applicable to contracts in the next cost accounting period beginning after receipt of a contract that incorporates the revised standard.

d. FAR 31.205-6(j)(1) makes CAS 412 applicable to all contracts, even contracts which are not CAS-covered or subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed pension costs, where significant, are in compliance with the provisions of CAS 412.

8-412.1 General **

a. The CASB defines a pension plan as a deferred compensation plan, established and maintained by one or more employers, to provide for systematic payment of benefits for life (or life at the option of the employees) to participants after their retirement. There are basically two kinds of pension plans: defined contribution plans and defined benefit plans. A defined contribution plan provides benefits to retirees according to the amount of the fixed contribution to be made by a contractor. The standard provides that the following types of plans shall be treated as defined contribution plans:

(1) plans which are funded through permanent insurance or annuity contracts,

(2) multi-employer plans established under collective bargaining agreements, and

(3) state pension plans applicable to Federally Funded Research and

Development Centers (FFRDCs).

In a defined benefit plan, the contributions to be made by the contractor are calculated actuarially to provide preestablished benefits. The cost of benefits under a pay-as-you-go plan must be measured in the same manner as the costs under a defined benefit plan. During the compliance audit, the auditor should identify the types of all pension plans in effect at the contractor locations.

b. Under the defined contribution plan, the pension cost of a cost accounting period is the net contribution required to be made, after adjustment for dividends and other credits. For a defined benefit plan the pension cost for a period may consist of four elements:

(1) Normal cost (annual cost attributable to years after a particular valuation date).

(2) Amortization of any unfunded actuarial liability (excess of the actuarial liability over the value of the pension fund assets).

(3) Interest equivalent on the unfunded actuarial liability and actuarial gains or losses being amortized.

(4) Adjustment for actuarial gains and losses (differences between forecasted assumptions and actual experience).

c. All portions of unfunded actuarial liability resulting from various events or circumstances (e.g., plan improvements or assumption changes) are to be included as separately identified parts of pension cost. In general, an unfunded actuarial liability will be amortized in equal installments over a period of not less than 10 and not more than 30 years (40 years if the plan predates January 1, 1974). CAS 412-50(a)(1) specifies a maximum and minimum amortization period for each portion of unfunded actuarial liability. If amortization has begun before the applicability date of the standard, the amortization period need not be changed. An interest equivalent on the unpaid balance of the liability must be included with each installment. Contractors must establish and consistently follow a policy for selecting specific amortization periods for unfunded actuarial liabilities. When selecting the specific amortization period with the above limits, the contractor's amortization policy may give consideration to the size and nature of the unfunded actuarial liability as a component of pension costs. Once the amortization period for a portion of unfunded actuarial liability is selected, the amortization process must continue to completion.

d. Pension costs applicable to prior periods which were specifically unallowable under then-existing contractual provisions should be separately identified and excluded from an amortization of unfunded liability or from future normal costs if the unfunded liability is not identified. Also excludable from pension costs are excise taxes and interest costs incurred as a result of inadequate or delayed funding.

e. Actuarial methods used by contractors may be classified as either the accrued

benefit cost method or one of the acceptable projected benefit cost methods. A major difference between methods is that, under the accrued benefit cost method, costs are based on units of future benefits which have been accrued to employees to the present date; whereas under the various projected benefit methods, costs are based on benefits which will accrue over the entire expected period of credited service of the individuals involved. The accrued and projected benefit cost methods are also grouped as either spread-gain or immediate-gain cost methods. Under the spread-gain method actuarial gains and losses are included as part of the normal cost for current and future years. Under the immediate-gain method actuarial gains and losses are separately identified and amortized over a period of years. The standard does not require the use of a specific actuarial cost method; however, the method selected by the contractor must provide for separate measurement of the pension cost elements listed in paragraph b. above. The cost elements are identified under the immediate-gain cost methods. They are not identified under spread-gain methods, which neither disclose actuarial gains and losses nor develop the amount of unfunded liability. Consequently, CAS 412 does not permit the use of spread-gain methods in calculation of pension cost for contract costing purposes

f. During the compliance audit, the auditor should identify the actuarial method used by the contractor for each plan in effect. The auditor should evaluate actuarial reports and statements, as well as accounting records.

g. The normal costs computed under the accrued benefit cost method are the present value of future benefits earned by employees during the year. For defined benefit pension plans other than those accounted for under the pay-as-you-go cost method where the pension benefit is a function of salaries and wages, the normal cost shall be computed using a projected benefit cost method. The normal cost for the projected benefit shall be expressed either as a percentage of payroll or as annual accrual based on the service attribution of the benefit formula. Where the pension benefit is not a function of salaries and wages; the normal cost shall be based on employee service.

h. While pension costs must be based on the provisions of existing plans, contractors may consider (1) salary projections for plans whose benefits are based on salaries and wages and (2) improved benefit projections for plans specifically providing for such improvements.

i. Actuarial assumptions are related to (1) interest or return on funds invested and (2) other projected factors such as future compensation levels, inflation, mortality, retirement age, turnover, and projected social security benefits. Each actuarial assumption used by the contractor in calculating pension costs must be identified separately. The assumptions should represent the contractor's estimated future experience based on long-term trends to avoid short-term fluctuations. Pursuant to CAS 412 in effect prior to March 30, 1995, the validity or the reasonableness of the actuarial assumptions can be measured in the aggregate of gains and losses rather than by a separate gain or loss analysis for each assumption. However, if the assumptions prove to be unreasonable in total; that is, the total gain or loss is

significant, the contractor must be able to identify the major causes and give reasons for either retaining or revising the assumptions. Under the revised CAS 412, the validity of each assumption used shall be evaluated solely with respect to that assumption. If the actuarial assumptions are revised, any resulting increase or decrease in the unfunded actuarial liability will be amortized over not less than 10 or more than 30 years. Support for each actuarial assumption used by the contractor should be critically examined by the auditor. The compliance audit should include steps to identify and evaluate the reasonableness of the assumptions and to monitor actuarial gains and losses to assure that the assumptions remain valid.

j. FAR has retained the requirement that pension contributions be funded in order to be allowable. Therefore, even though the standard provides criteria for measurement and assignment of pension costs, the auditor will continue to establish the allowability of pension costs in accordance with FAR requirements.

k. In accordance with FAR 52.230-6, a contractor is required to describe to the CFAO the kind of changes made in order to comply with a new or modified cost accounting standard. This includes the modifications to CAS 412 effective March 30, 1995. The description should be submitted within 60 days after the award of a contract to which the standard or a modification to the standard is applicable. This should be done whether or not the contractor has filed a Disclosure Statement. If it appears that accounting changes will be required as a result of CAS 412, or the March 30, 1995 modifications thereto, and the contractor has not submitted the description on time, the auditor should advise the CFAO.

l. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-412.2 Assignment of Pension Cost **

a. Pre - March 30, 1995 Requirements:

(1) Pension costs computed for a cost accounting period are assignable to that period only, except when a payment deferral has been granted under the provisions of ERISA. ERISA permits a contractor which has received a funding deficiency waiver for a particular year to amortize related pension costs over the immediately succeeding 15 years. Pension costs deferred to future periods under this provision must be assigned to the periods in which the funding actually takes place. However, in accordance with the first sentence of FAR 31.205-6(j)(2)(i)(A) and CAS 412-50(a)(2)(ii), the interest equivalent on the unfunded actuarial liability which results from this delayed funding would be unallowable.

(2) Except for pay-as-you-go plans, the cost assignable to a period is allocable to cost objectives of that period if (a) costs are funded in the period or (b) funding can be compelled. Costs will be considered funded for a period if payment is made by the Federal income tax return due date, including any extension. Funding provisions in ERISA, contractual funding agreements, or existence of third-party rights to required funding would constitute evidence that funding can be compelled. Excess

funding is considered applicable to future periods.

b. Requirements Effective March 30, 1995:

(1) Pension cost computed for a cost accounting period is assignable only to that period, except for costs assigned to future periods pursuant to CAS 412-50(c)(2) and (c)(5). The provisions at CAS 412.50(c)(2) establish a ceiling and floor (assignable cost corridor) on the amount of pension cost assignable to a period. According to the new rules, the pension cost assignable to a cost accounting period may not be less than zero (floor) nor exceed the ERISA maximum tax-deductible (ceiling) amount. The pension costs initially computed for a cost accounting period are adjusted for amounts that fall outside the assignable cost corridor. The adjustments (amounts falling outside the corridor) are reassigned to future periods as an assignable cost credit (amount less than zero), or assignable cost deficit (amount over ceiling). The credit or deficit amounts are amortized over a 10 year period in accordance with provisions prescribed at CAS 412.50(a)(1)(vi). Also, in accordance with CAS 412.50(c)(5), pension cost not funded pursuant to an ERISA funding waiver is reassigned to future periods as an assignable cost deficit subject to amortization using the same amortization period as used for ERISA purposes.

(2) Under the pre-March 30, 1995 rule, pension costs assigned to a cost accounting period were allocable to cost objectives of that period if liquidation of the liability could be compelled. However, pursuant to the revised standard, except for nonqualified defined benefit plans, the entire pension cost assigned to a cost accounting period must be funded in order to be allocable to cost objectives (CAS 412.50(d)(1)).

8-412.3 Full Funding Limitation **

Requirements Effective March 30, 1995: The revised standard at CAS 412-30(a)(9) defines the CAS full funding limit (Assignable Cost Limitation) as the excess, if any, of the actuarial liability plus the current normal cost over the actuarial value of the pension plan assets. The amount of pension cost assigned to a cost accounting period cannot exceed the CAS full funding limit. Thus, when the Assignable Cost Limitation applies all prior year amortization bases are considered fully amortized (Fresh Start). The revised standard also eliminates the conflict between the CAS and ERISA/IRC full funding limitation by limiting the amount of pension cost assignable to a cost accounting period to the maximum tax-deductible amount. The amount of pension cost computed for a period in excess of the tax-deductible limit is reassigned to future periods as an assignable cost deficit which is amortized over a ten year period.

8-412.4 Nonqualified Plans **

a. Pre-March 30, 1995 Requirements: Pay-as-you-go plans are different from trusteed or insured plans in that they are not funded. Therefore, the cost of benefits under a pay-as-you-go plan shall be measured the same as costs of defined benefit plans whose benefits are funded. Costs assignable to a period under a pay-as-you-go plan are allocable to the cost objectives of the period only if the payment of benefits is made in that period or can be compelled. If payment is optional with the contractor,

costs allocable to cost objectives of the period are the lesser of the amount of benefits actually paid to beneficiaries in that period or the amount computed as assignable to that period.

b. Requirements Effective March 30, 1995: The pre - March 30, 1995 provision at CAS 412-40(c) which allowed contractors to accrue pension cost for nonqualified plans if benefits could be compelled has been deleted. The revised standard permits contractors to accrue pension cost for nonqualified plans only if the requirements set forth in CAS 412-50(c)(3) are satisfied. The three requirements specified in this provision are (1) the contractor elects to use accrual accounting, (2) the plan is funded through a funding agency, and (3) the benefits are nonforfeitable. The costs of nonqualified plans which do not meet these requirements shall be assigned to cost accounting periods using the pay-as-you-go cost method. With regard to the funding requirement for nonqualified plans, the standard requires partial funding at the tax rate complement (i.e., 100% minus the tax rate %).

8-412.5 Illustrations **

The following illustrations are intended to supplement those in paragraph 412-60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the standard.

a. **Problem.** A contractor uses an immediate-gain actuarial cost method in computing pension cost for contract costing purposes. The contractor has proposed $2.3 million pension costs for the current cost accounting period. The auditor’s analysis of the actuarial valuation report disclosed that:

(1) the value of the pension fund assets was $12.6 million,

(2) the actuarial liability was $10 million, and

(3) the experienced actuarial gain for the previous period was $1 million.

Solution. The pension cost assignable to the cost accounting period is $-0-, because the value of the pension assets exceeds the actuarial liability plus the normal cost for the period. In other words, there is no valid liability and therefore no basis for recognition of pension accruals on Government contracts. Furthermore, the significance of the experienced actuarial gain would indicate that the actuarial assumptions may not be reasonable. The contractor should be required to identify the actuarial assumptions that were responsible for the gain and to provide rationale for either retaining or revising those assumptions.

b. **Problem.** As a result of a temporary cash shortage, a contractor's payments into the pension fund were not adequate to meet the ERISA funding requirements for the period. A 5-percent excise tax on the accumulated funding deficiency was therefore assessed against the contractor. In computing the pension cost for the fiscal year, the contractor included the assessment of the 5-percent tax plus an interest equivalent on the unpaid amount.

Solution. Both the excise tax, which was assessed as a penalty for the delayed payment, and the interest equivalent on the delayed payment should be excluded from the pension costs allocated to Government contracts. The CASB, in its prefatory comments to the standard, acknowledged that an interest equivalent should be recognized to determine whether a pension plan is properly funded. However, since interest resulting from delayed funding is caused by a management decision to use funds for other purposes, the interest should be considered as investment cost rather than a component of pension cost.

8-413 Cost Accounting Standard 413 - Adjustment and Allocation of Pension Cost **

a. This standard establishes criteria for:

(1) assigning actuarial gains and losses to cost accounting periods,

(2) valuing pension fund assets, and

(3) allocating pension costs to segments.

b. Provisions in the standard are somewhat more stringent than ERISA requirements, concerning frequency of actuarial valuations and methods of valuing pension fund assets. Consequently, some accounting changes may be required for compliance with the standard in addition to those previously made to comply with ERISA.

c. FAR 31.205-6(j)(1) makes CAS 413 applicable to all contracts, even contracts which are not CAS-covered or are subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed pension costs, where significant, are in compliance with the provisions of CAS 413.

d. CAS 413 was effective March 10, 1978 and must be followed in the next fiscal year after award of a CAS covered contract to which it is applicable. CAS 413 was revised effective March 30, 1995 and the revised CAS 413 must be followed in the next fiscal year after award of a CAS covered contract to which it is applicable. However, a significant feature of the revised CAS 413 is the CAS Board's clarification on application of CAS 413-50(c)(12) with respect to adjustments to previously determined pension costs in the event of segment closing, pension plan termination or curtailment of pension plan benefits. The revisions to CAS 413-50(c)(12) clarify and specify techniques for determining such adjustments. According to CAS 413 transition coverage, these clarifications should be used to resolve outstanding issues on existing CAS covered contracts.

8-413.1 General **

a. Actuarial gains and losses represent differences between actuarial assumptions and actual experience. As previously noted in 8-412.1i., actuarial assumptions are related to:

(1) interest or return on funds invested and

(2) other projected factors such as future compensation levels, inflation, mortality, retirement age, turnover, and projected social security benefits.

CAS 413 requires that actuarial gains and losses for defined benefit plans be calculated annually and assigned to current and subsequent cost accounting periods. Under pension plans whose costs are determined by an immediate gain actuarial cost method, gains and losses that are material will be amortized equally over 15 years beginning with the current period. The annual installment will include an interest equivalent on the unamortized balance at the beginning of the period. Immaterial gains or losses may be assigned to the current period. An immediate gain method is one in which actuarial gains and losses are determined separately as an adjustment to the unfunded actuarial liability. Included in this category are the accrued benefit and entry age normal (sometimes referred to as the individual level premium with supplemental liability) actuarial cost methods.

b. The original and revised standard permits use of any recognized method for valuing pension fund assets used in measuring pension cost components provided it reflects appreciation and depreciation of pension fund assets and is used consistently from year to year. The illustration in CAS 413-60(b) identifies some commonly used asset valuation methods:

Type of Asset	Basis for Valuation
Equity securities and debt securities not expected to be held to maturity	5-year moving average of market values
Debt securities expected to be held to maturity	Amortization of differences between cost at purchase and par value at maturity
Real Estate	Cost less accumulated depreciation

If the method produces a value of less than 80 percent or more than 120 percent of market value, the asset values in a given year must be adjusted to the nearest 80 percent or 120 percent boundary. The adjusted asset values are then considered in calculating the actuarial gain or loss subject to the amortization criteria described above. The standard's provisions regarding the valuation of assets do not apply to plans funded with insurance companies via contracts with guaranteed benefits.

8-413.2 Segment Accounting **

a. Pre-March 30, 1995 Requirements:

(1) Except where certain significant disparities in actuarial factors exist between segments, contractors have the option to calculate pension costs either

separately for segments or on a composite basis for allocation to segments on a base that represents the factors used in computing pension benefits. Separate calculations of pension costs for each segment are acceptable. CAS 413-50(c)(2) and (3) provide that pension costs must be separately calculated for a segment (on a prospective basis) when the pension costs at the segment are materially affected by any of the following conditions:

(a) The segment experiences material termination gains or losses.

(b) The level of benefits, eligibility for benefits, or age distribution is materially different for the segment than for the average of all segments.

(c) The aggregate of actuarial assumptions for termination, retirement age, or salary scale is materially different for the segment than for the average of the segments.

(d) The ratios of assets to actuarial liabilities for merged segments are different from one another after applying the benefits in effect after the merger. Differences between segments as to level of benefits and eligibility of benefits should be obtainable from the provisions of the pension plan. Segment data for termination experience, age distribution, and actuarial assumptions for termination, retirement age or salary scale will generally not be included in actuarial reports, CPA reports, IRS Form 5500 or other pension source documents. Thus, the auditor should attempt to gain an understanding at the onset of the pension evaluation as to the segment data to be provided by the contractor that are necessary for audit determination of compliance with CAS 413-50(c)(2) and (3).

(2) When separate pension fund calculations are required because of disparities in termination gains or losses, level of or eligibility for benefits, or actuarial assumptions for termination, retirement age or salary scale, undivided pension fund assets must be initially allocated to the segment for which the separate calculation is being made. The value of the pension fund assets allocated shall equal the segment's pension fund contributions, adjusted for earned interest and paid benefits/expenses, if such information is determinable; if not, the assets can be allocated among segments on any ratio which is consistent with the actuarial cost method(s) used to compute pension costs. The initial allocation of assets to merged segments must be the market value of the segment's pension fund assets when the merger occurred.

(3) Employees participating in a multisegment pension plan occasionally transfer between segments. However, the applicable pension fund assets and liabilities need not follow the employees from one segment to the other unless the transfers involve such a large number of employees that a segment's ratio of fund assets to actuarial liabilities would be distorted.

(4) Contractors who separately calculate pension costs for one or more segments have the option of establishing a separate segment for inactive participants (e.g., retirees). If this action is taken, the pension fund assets and actuarial liabilities

should be transferred to the inactive segment when employees participating in the pension plan become inactive. The funds transferred are to reflect the funded portion of the inactive participants' actuarial liability. CAS 413-50(c)(1) and 413-50(c)(9) provide that inactive segment costs shall be allocated to the segments with active lives on a basis representative of the factors upon which pension costs are based. Thus, pension cost calculated for the inactive participants should be allocated to the segments with active lives on a basis that is relatively comparable to the amounts that would have been computed if a separate segment for inactives had never been established.

b. Requirements Effective March 30, 1995:

(1) The provisions of CAS 413-40(c) now provide clear and concise criteria for determining the funding status for pension plans at contractors that compute pension cost on a segmented basis. Specifically, the revised coverage provides that computation of the assignable cost limitation shall be based on the assets and liabilities of the individual segment. The revisions also provide that in computing the limit on the amount of assignable cost for a segment, the measurement of the ERISA tax deductible amount is computed for the plan as a whole and apportioned among the segments. Amounts funded (contributions) can be allocated to Government segments first.

(2) The revised Standard provides specific coverage for calculation of segmented pension cost for segments that have disproportionate ratios of assets to liabilities. Under the revised coverage, when the assignable cost limitation applies to a particular segment, all existing amortization bases maintained for that segment are considered fully amortized (fresh-start) pursuant to the provisions of CAS 412-50(c)(2). For those segments not affected by the assignable cost limitation, the amortization of the unfunded actuarial liability continues unabated. In addition, any amount of pension cost not assignable to a segment due to application of the ERISA tax-deductible limit is reassigned to future periods as an assignable cost deficit.

8-413.3 CAS 413-50(c)(12) Adjustment For Segment Closing, Plan Termination or Benefit Curtailment **

a. When a segment is closed, a plan is terminated, or benefits are curtailed, the contractor must determine the difference between the actuarial liability for the segment and the market value of the assets allocated to the segment as of the closure date. Although this difference represents an adjustment of previously determined pension costs, the general rule is that the contractor should make a refund or give credit to the Government for its equitable share in the cost accounting period of closure, not prior cost accounting periods. However, if the contractor continues to perform Government contracts, the contracting parties may agree to apply the credit or charge in costing of future contracts.

b. A new definition has been added at CAS 413-30(a)(20) with specific criteria for determining when a segment is closed. The definition describes three events that would give rise to a segment closing within the context of CAS 413-50(c)(12). The first event is when a change in ownership takes place and such change involves more than a mere reorganization within the contractor’s internal structure. The second event is

when the segment operationally ceases to exist. The third is when the segment ends its contractual relationship with the Government irrespective of whether the segment continues in operation.

c. Clarifications on Application of CAS 413-50(c)(12):

(1) In lieu of requiring contractors to recognize negative pension cost for severely overfunded plans, specific language has been added to CAS 413-50(c)(12) that clarifies the Government's rights to an adjustment in the case of a segment closing, plan termination, or freezing of benefits (curtailment of benefit gain/loss). The revised Standard retains the principle of deferring the Government's recovery of excess assets until the occurrence of an event that triggers the application of CAS 413-50(c)(12).

(2) The coverage has been strengthened to provide greater specificity regarding the methodology and assumptions to be used in calculating the adjustment. The revised coverage also clarifies that the adjustment results in a charge to Government contracts when the liabilities of the plan exceed the assets. The revised Standard also provides clarification on the application of CAS 413-50(c)(12) in the following areas:

(a) **Actuarial Assumptions - 413-50(c)(12)(i)**: The actuarial liability shall be determined using the accrued benefit cost method based on the long term assumptions used by the contractor in measurement of pension cost on Government contracts. This clarification resolves the issue of whether measurement of the liability is based on the Accumulated Benefit Obligation (an ABO calculation) or the Projected Benefit Obligation (PBO). Clarified coverage requires that the liability be based on the accrued benefit cost method (ABO). The coverage also clarifies that in the absence of a plan termination or settlement of liabilities, contractors are required to use the plan's existing long term actuarial interest rate assumption in measurement of the segment's actuarial liability. As such, the use of the PBGC or ERISA interest assumption would be inappropriate unless the plan is terminated or the pension obligations are settled by the purchase of annuity contracts.

(b) **Plan Improvements -.413-50(c)(12)(iv):** The revised coverage incorporates a 5 year phase-in rule in which increased liabilities are recognized on a prorata basis using the number of months that the plan amendment preceded the date of the event that triggers an adjustment. This provision provides clarification in accounting for plan improvements adopted within 60 months of the event date. The revised coverage makes it clear that contractors must give consideration to this ERISA requirement in measurement of liabilities due to plan amendments. The cost of increased benefits that are not required by law or by a collective bargaining agreement are subject to the sixty month phase-in requirement.

(c) **Transfer of Assets/Liabilities - 413-50(c)(12)(v):** This provision provides clarification on the accounting for pension adjustments when the segment closing involves the transfer of pension assets and liabilities. According to the clarified coverage, no adjustment is required when all the pension assets and liabilities are

transferred to a successor in interest to the contracts. On the other hand, if only a portion of the assets and liabilities are transferred, the standard requires that the adjustment be determined after consideration for any transfer of assets and liabilities to a successor contractor.

(d) **Adjustment to Pension costs - 413-50(c)(12)(vi):** The Government's share of the pension adjustment is determined based on the cost allocated to all contracts that are subject to the provisions of CAS 412/413. This coverage makes it clear that CAS covered firm-fixed-price contracts are included in calculation of the segment closing adjustment.

d. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-413.4 Illustrations **

The following illustrations supplement those in paragraph 413-60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the standard.

a. **Problem.** Contractor X was acquired by Contractor Y and renamed Segment B. The entire work force of X was retained by Y following the acquisition. Pursuant to terms of X's pension plan, X employees were paid all vested pension benefits at the time of dissolution of X. The employees, upon coming to work for Contractor Y, were considered "new employees" with no actuarial liability attributable to their past service with Contractor X. Contractor Y's unfunded actuarial liability (UAL) at the time of the merger was $25 million. Contractor Y has consistently made a composite pension cost calculation for all of its segments and wishes to continue doing so.

Solution. Since Y's pension plan had a disproportionately larger UAL than X's plan at the time of acquisition (i.e., $25 million vs. -0-), any combining of assets and actuarial liabilities of the two plans would result in a materially different pension cost allocation to Y's segments than if pension costs for Segment B were computed as though it had a separate pension plan. Pension costs must be calculated separately for Segment B.

b. **Problem.** Contractor X computes pension costs separately for Segments A, B, and C. As permitted in CAS 413-50(c)(9), the contractor elects to establish a separate segment for inactive plan participants. Pension costs for the inactive segment are allocated back to A, B, and C on the ratios of the remaining working lives of the work force of the three segments. This method results in the following allocation of inactive segment pension costs:

Segment	Costs	%
Segment A	$2.5 million	25

Segment B	4.0 million	40
Segment C	3.5 million	35
Total inactive segment costs allocated	$10.0 million	100%

The actuarial report discloses that the inactive plan participants retired from the following segments:

Segment	Number of Retirees	%
A	5950	85
B	350	5
C	700	10
Total	7000	100%

Due to the geographical dispersion of the three segments, few employees had transferred among segments prior to retirement. The high ratio of retirees from Segment A was attributable to a major plant layoff that occurred 10 years previously.

Solution. The contractor's allocation of inactive segment costs to Segments A, B, and C results in a substantially different amount than would have been allocated if a separate segment for inactive participants had never been established. The auditor should recommend an allocation of inactive segment costs to A, B, and C based on the ratios of the number of retirees from each segment to total retirees.

8-414 Cost Accounting Standard 414 - Cost of Money as an Element of the Cost of Facilities Capital **

a. The standard recognizes the cost of facilities capital as a contract cost. It provides criteria for measuring and allocating an appropriate share of the cost of money which can be identified with the facilities employed in a business.

b. The effective date of this standard was October 1, 1976. Contractors must follow its requirements on all contracts subject to CAS negotiated on or after this date.

c. CAS 414 and the FAR cost principle do not apply to facilities where compensation for the use of the facilities is based on use rates or allowances in accordance with Federal regulation. Where contractors are compensated for some facilities by use rates and others by depreciation, the contractor should apply CAS 414 to those facilities that are being depreciated.

d. FAR 31.205-10 makes CAS 414 applicable to all contracts, even contracts that

are not CAS-covered or subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed cost of money, where significant, are in compliance with the provisions of CAS 414.

e. See CAS Working Group Papers 77-18 and 77-19 for guidance issued by the CAS Working Group on CAS 414.

8-414.1 General **

a. The CAS 414 techniques must be used to compute the cost of money in connection with individual price proposals, forward pricing rate agreements, and with the establishment of final indirect cost rates. The cost of money is an imputed cost, which is identified with the total facilities capital associated with each indirect cost pool, and is allocated to contracts over the same base used to allocate the other expenses included in the cost pool. The cost of money may be considered an indirect expense associated with an individual cost pool but separately identified. The cost of money is subject to all the same allocation procedures as any other indirect expense which is allocated on a selected base, and each element of such base, whether allowable or unallowable, should bear its pro rata share of the cost of money.

b. Use of the cost of money factors in final indirect rate determinations and forward pricing proposals is discussed in paragraphs 8-414.2 and 8-414.3 below. The calculation of the cost of money for each contract involves several steps.

(1) The average net book value of facilities for each indirect expense pool having a significant allocation of facilities is identified from accounting data used for contract costing.

(2) The cost of money devoted to facilities capital for each indirect expense pool is the product of these net book values multiplied by the cost of money rates per the Secretary of the Treasury under Public Law 92-41, 85 Statute 97 (distributed semi-annually by Headquarters).

(3) Facilities capital cost of money factors are computed by dividing the cost of money for each pool by the corresponding allocation base. The allocation bases used in this computation must be compatible with the bases used for applying indirect costs in determining contract costs.

(4) The cost of capital committed to facilities is separately estimated, accumulated, and reported for each contract. Each contract's share of the facilities capital cost of money is determined by multiplying the portion of the allocation bases for each indirect expense pool applicable to the contract by the facilities cost of money factor for that pool and adding the products together.

c. The facilities capital cost of money factors, wherever applicable, must be computed in accordance with the CASB-CMF form, Facilities Capital Cost of Money Factors and Computation. The CASB-CMF form and instructions are included as an appendix to CAS 414.

(1) On the CASB-CMF form, facilities capital items are classified as Recorded Facilities, Leased Property, and Corporate or Group Facilities. Capital leases are to be considered as Leased Property for purposes of the CASB-CMF form. In accordance with CAS Working Group Paper 77-19, operating leases, for which constructive cost of ownership is allowed in lieu of rental costs under Government acquisition regulations, are also to be classified as Leased Property. Since cost of money would be an allowable cost if the contractor had purchased the property, the cost of money should be included as an ownership cost in determining whether the allowable cost will be based on constructive ownership cost or leasing cost. Land which is an integral part of the leased facility is subject to the same treatment as the leased facility in computing the cost of money. Land leases for which the land is used in the regular business activity will also be included on the form even though land lease costs themselves do not generate allowable costs.

(2) Facilities costs are further identified on the CASB-CMF as either "distributed" or "undistributed. "Distributed facilities are those capital items which can be identified in the contractor's records as solely applicable to those specific indirect expense pools for which a cost of money rate is to be computed. Undistributed items, which represent the remainder of the business unit's facilities capital, consist primarily of items charged to service centers. Under the regular method, undistributed assets are allocated to the appropriate indirect expense pools on a basis that approximates the actual absorption of depreciation/amortization of the facilities. Under the alternative method provided for in the standard, the undistributed assets are allocated to the G&A expense pool. The alternative method may be used only if the contracting parties agree that depreciation/amortization generated by the undistributed assets is immaterial or the results obtained from this alternative procedure are comparable to those which would have been obtained under the regular method.

(3) In determining the average net book values for facilities employed by the business unit, auditors will be required to examine asset records to the extent necessary in the circumstances.

(a) Initially, the auditor should establish the validity of the average values used by the contractor. The standard provides that, where there has been a major fluctuation in the level of facilities during the cost accounting period, the simple average of the beginning and ending net book values may not be appropriate. Where significant variations have occurred, the auditor should recommend a procedure for calculating the average that more accurately reflects the actual experience.

(b) The facilities capital values used as a basis for the cost of money must, in general, be the same values used to generate allowable depreciation or amortization cost (ASBCA Case No. 32419, Raytheon Co.). Land which is integral to the regular operation of the business unit will be included. Operating leases which are treated as constructive ownership will be included at net book value on the CASB-CMF form starting with beginning of the lease term. Where leasing costs have previously been accepted as less costly to the Government under the lease period, renewal of the lease requires a new comparison of lease/ownership costs. If this comparison results in the

allowance of constructive ownership costs in lieu of rental costs, the lease will be included at net book value on the CASB-CMF starting with the beginning of the lease renewal. The net book value will be based on fair value at asset acquisition (date that lease was entered into or renewed if appropriate) less the amount, if any, which would have been depreciated had the asset been purchased. The net book value assigned to the leased asset will not include the cost of money. Leasehold improvements may be considered in computing the cost of money if they are subject to amortization. Goodwill is not to be included in the cost of money computation. The acquisition value for all contractor-owned tangible assets and those leased assets for which constructive cost of ownership is allowed in lieu of rental costs should be determined in accordance with CAS 404. Depreciation charges applicable to assets included in the cost of money computation will be determined in accordance with CAS 409.

(c) To be included in the base for the cost of money computation, the asset must be used in regular business activity. Where a contractor maintains depreciation records for groups of assets, the auditor should evaluate the assets in the group to see if they should be included in the cost of money computation. In addition, the auditors should carefully evaluate contractor land purchases and leases to determine if they are an integral part of the regular operation of the business. The auditor should request the contractor to demonstrate that land purchases and leases in question were acquired as a reasonable response to a prudent forecast of the contractor's regular business activity and therefore are integral to the regular operations of the business. If the purchase/lease costs do not meet this requirement then the auditor should assure that these costs are properly excluded from the CAS 414 computation. The following would not be considered as being used in the regular business activity:

- Land held for speculation.
- Facilities or capacity which have been determined to be idle in accordance with FAR 31.205-17.
- Assets which are under construction for a contractor's own use (see 8-417.2a.).
- Assets which have been constructed or purchased but have not yet been placed into service.

8-414.2 Interest Rates – Cost of Facilities Capital **

a. The cost of money rate to be used in computing the cost of money factors is determined by the Secretary of the Treasury under Public Law 92-41, 85 Statute 97. This rate is published semiannually in the Federal Register. The rate published in December is applicable to the period from January 1 through June 30; the rate published in June is applicable to the period from July 1 through December 31. Although the interest rates are published semiannually, they are annual rates. Rates in effect since January 1, 2000 are as follows:

Year	January-June	July-December

Year	January-June	July-December
2000	6.75%	7.25%
2001	6.375%	5.875%
2002	5.5%	5.25%
2003	4.25%	3.125%
2004	4.00%	4.5%
2005	4.25%	4.5%
2006	5.125%	5.75%
2007	5.25%	5.75%
2008	4.75%	5.125%
2009	5.625%	4.875%
2010	3.25%	3.125%
2011	2.625%	2.500%
2012	2.000%	1.7500%
2013	1.375%	1.75%
2014	2.125%	2.0%
2015	2.125%	2.375%
2016	2.50%	1.875%
2017	2.50%	2.375

b. In calculating final facilities capital cost of money factors, the cost of money rate is the prorated average of the treasury rates. For example, the cost of money rate for fiscal year ending October 31, 2016 should be computed as follows:

Period	Treasury Rate	Weighting	Cost of Money Rate
2015 2nd Half	2.375%	2/12	0.396%
2016 1st Half	2.50%	6/12	1.25%

2016 2nd Half	1.875%	4/12	0.625%
Total			2.271%

The contractor must compute and support the cost of money factors. Based on the auditor's recommendation, the CFAO determines whether the factors are valid for contract cost and pricing purposes.

c. A contractor may change its fiscal year due to a merger, business combination, or other valid reason. When a cost accounting period is not a 12-month period, the cost of money rates must be adjusted to reflect the applicable accounting period. This is because the cost of money rates are annual rates, whereas the asset net book values of the contractor's assets and allocation bases reflect a period other than the normal 12-month period. For example, the cost of money rate for a 6 and 15 month accounting periods ending December 31, 2015 would be computed as follows:

6-Month Accounting Period

Period	Treasury Rate	Weighting	Cost of Money Rate
2016 2nd Half	1.875%	6/12	0.938%

15-Month Accounting Period

Period	Treasury Rate	Weighting	Cost of Money Rate
2015 2nd Half	2.375%	3/12	0.594%
2016 1st Half	2.50%	6/12	1.25%
2016 2nd Half	1.875%	6/12	0.938%
Total			2.785%

8-414.3 Evaluating the Contractor's Computations **

a. The CASB-CMF form will be used to support the cost of money factors used in incurred cost allocations and forward pricing proposals. In developing the factors used in forward pricing proposals, the contractor should take into account the latest available cost of money rate and a forecast of the facilities net book values and allocation bases for each cost accounting period of contract performance. In some instances, where projected asset value and allocation bases are not expected to vary significantly from the

latest completed cost accounting period, the same facilities values and allocation bases as are required for retroactive cost determination may be used for forward pricing purposes.

(1) In as much as significant changes in any of the variables, i.e., net book value of facilities, the treasury rate or the allocation base may change the relationship and affect the cost of money factor, the auditor should closely evaluate any proposed cost of money calculation before it is accepted as a basis for negotiation. The latest available semiannual interest rate should be verified and known or anticipated additions/deletions of assets, as well as the effect of the annual depreciation on the net book value, should be examined. The allocation bases used in the cost of money computation should be compared for consistency with those used in estimating indirect cost rates.

(2) When the average cost of money rate to be used in costing the contract is known, this average rate should be used in lieu of the latest semiannual treasury rate. This situation could occur when a short-term contract is negotiated and performed within the 6-month period after all the rates to be weighted in the actual historical cost of money are known. As an example, a contractor on a calendar year basis receives a contract on July 1, 1987, with a performance period of July 1, 1987 to December 31, 1987. The treasury rate for July 1, 1987 to December 31, 1987 was published in June 1987. Since the contract will be costed after-the-fact using the arithmetic average of the two semiannual rates for 1987, 7.625% + 8.875%/2 = 8.25%, the 8.25 percent rate should also be used for pricing the contract. Auditors should be aware that the interest rate which will be in effect during the negotiation and applied to the contractor's estimate may not be known when the audit report is written. If this is the case, we should qualify the audit report regarding the allocable cost of money. The qualification should advise that if a new rate is available, the PCO should consider recomputing the cost of money amount before finalizing negotiations.

b. In accordance with CAS 414, cost of money is allocable to IR&D and B&P projects.

c. Contractors will include the amount proposed for cost of money in the proposal, supported by Form CASB-CMF and any other detail required to comply with 10 U.S.C. 2306a, Truth in Negotiations. Where the contractor elects to exclude the cost of money from its proposal or claim for reimbursement, such costs should be designated as unallowable and may not be included in profit. In addition, the contractor is still required to compute the cost of money factors in accordance with CAS 414. The failure to make the computation is considered a violation of a major requirement of the standard. In virtually all cases, however, the noncompliance will not result in increased cost paid by the Government. We should therefore issue noncompliance reports only if the acquisition office or the CFAO requests them. If no such request is made, we will advise the CFAO by memorandum of the technical noncompliance. We will also include appropriate comments in the proposal audit report as well.

d. Request for audits of the contractor's computation of the cost of money may be

received in connection with individual price proposals, forward pricing rate agreements, and the establishment of final indirect cost rates. With each of these audits, the report to the CFAO will state whether the contractor has complied with the standard and the requirements of the acquisition regulations.

e. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-415 Cost Accounting Standard 415 - Accounting for the Cost of Deferred Compensation **

a. The purpose of this standard is to provide criteria for measuring deferred compensation costs and assigning those costs to cost accounting periods. It applies to all deferred compensation costs except for compensated absences and pension costs covered in CAS 408 and CAS 412.

b. The standard was effective July 10, 1977. It must be applied to all new deferred compensation awards made in the next fiscal year after receipt of a CAS-covered contract to which the standard is applicable. It does not disturb the contractual provisions applicable to prior awards. It allows the deferred compensation cost awarded before the applicability date to be allocated as a cost when paid under existing contracts.

c. FAR 31.205-6(k) makes CAS 415 applicable to all contracts, even contracts which are not CAS-covered or subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed deferred compensation costs, where significant, are in compliance with the provisions of CAS 415.

8-415.1 General **

a. Deferred compensation is an award made by an employer to compensate an employee in a future cost accounting period for services rendered prior to receipt of compensation. It does not include normal year-end salary, wage, or bonus accruals.

b. Deferred compensation costs are measured by the present value of future benefits to be paid and are assigned to the cost accounting period in which the contractor becomes obligated to compensate the employee. The contractor incurs this obligation when:

(1) The requirement for future payment cannot be unilaterally avoided by the contractor.

(2) The award is to be paid in money, other assets, or shares of the contractor's stock.

(3) The future payment can be measured reasonably accurately.

(4) The recipient of the award is known.

(5) Events entitling an employee to receive an award have a reasonable probability of occurrence.

(6) There is reasonable probability that stock options will be exercised. These conditions are basically those recognized under generally accepted accounting principles for establishing a liability. Where these conditions are not met, the deferred compensation cost will be assigned to the period of payment.

c. If the award is based on employee's performance of future service to receive benefits, the contractor's obligation is established as the future service is performed.

d. The treasury rate determined by the Secretary of the Treasury pursuant to Public Law 92-41, 85 Statute 97, effective when the cost is assigned, will be used for computing the present value of future benefits. The treasury rate considers current private commercial interest rates for loans maturing in approximately five years and is considered the most appropriate rate for discounting deferred compensation costs.

e. The measurement and assignment of present values of future benefits to cost accounting periods should be separate for each award. However, the cost estimated on a group basis for employees covered by a deferred compensation plan will be acceptable if the cost can be measured with reasonable accuracy and includes an adjustment for probable forfeitures.

f. The auditor's evaluation should:

(1) Identify all deferred compensation awards currently provided to employees.

(2) Determine what accounting changes, if any, are contemplated as a result of the standard. (According to FAR 52.230-6, the contractor is required to describe to the ACO the kind of changes required by the standard.) If the contractor previously utilized a cash basis of accounting for deferred compensation costs on Government contracts, a change from a cash to an accrual basis will be required for all new awards made after the applicability date of the standard.

(3) Verify, through examination of the award provisions, that all applicable conditions for establishing the obligation for compensation have been met for those awards in which the entire cost is recognized in the year of award.

(4) Evaluate the present-value calculations to determine that the treasury rate specified in the standard has been used correctly.

(5) Evaluate costs for proper credit of estimated forfeitures, based on past experience and future expectations, where deferred compensation costs are accounted for on a group basis.

g. Interest cost will be included in computing future benefits for all deferred compensation cash awards that provide for the payment of interest. The allowability of

such interest cost will be determined in accordance with applicable acquisition regulations. If the award stipulates a fixed interest rate, the interest cost is assigned at the fixed rate to the cost accounting period in which the contractor is obligated to compensate the employee. Some deferred compensation awards provide for the payment of interest at variable rates from the date of the award until payment. When the variable rate is based on specified index that is determinable by cost accounting period, the interest cost is assigned to the applicable period at the actual rate for the index at the close of the period. Since that rate may vary from the actual rates in future periods, adjustments will be made in any future period in which the variable rate materially affects the cost of deferred compensation. When the variable rate is not based on a specified index and is not determinable by year, the total interest cost will be assigned to the period of payment. The auditor should evaluate each deferred compensation plan that provides for a cash award, to determine whether the payment of interest is required. For each plan that provides for interest, the auditor should check the contractor's annual interest cost calculation to ascertain that only interest costs for which the rates are fixed or based on specific indices have been accrued.

h. If a deferred compensation plan for a cash award requires irrevocable funding (including interest) of future payments to employees, the amount irrevocably funded will be assigned to the cost accounting period in which the funding occurs.

i. The deferred compensation cost of an award of contractor stock will be based on the current or prevailing market value of the stock (as indicated by market quotations) on the date the number of shares awarded becomes known. It should be noted that the standard does not provide for present value discounting of the market price for stock. Since the market price is presumed to reflect future expectations, further discounting would not be appropriate.

j. The cost of an award of an asset other than cash will be based on the market value of the asset when the award is made. If the market value is not available, a fair value of the asset will be established. The auditor should verify that the claimed market value of the asset is supported by a valid appraisal obtained from an outside source.

k. If the terms of an award of either cash, other assets, or stock require that an employee perform future service to receive benefits, the deferred compensation cost will be assigned on a pro rata basis to those applicable periods of current and future service. The standard does not specify the method or proration but provides that the proration be based on the circumstances of the award. The requirement of the standard conforms with Accounting Principles Board Opinion No. 12 which states that only the portion applicable to the current period should be accrued if elements of both current and future services are present. The auditor should determine the basis on which the contractor prorates costs between current and future periods. Where deferred compensation plans do not clearly establish a basis for prorating costs between accounting periods, the contractor will be required to support the prorations. In most instances, the contractor, because of the ease of computation, will prorate the costs evenly over the number of years of additional service required before exercise of the award. For example, a contractor, declaring a year-end cash award to key employees

under a plan requiring three additional years of service before payment, prorates the cost evenly over the following three years (excluding adjustment for present value factors). The contractor's proration would be accepted by the auditor unless the circumstances of the award clearly indicated that the award was related in total, or in part, to past services rendered.

l. Any forfeiture that reduces the contractor's obligation for payment of deferred compensation will be credited to contract costs in the period the forfeiture occurs. The reduction will be the amount of the award assigned to the prior period(s), plus interest compounded annually at the Secretary of the Treasury rate under Public Law 92-41, 85 Statute 97. For irrevocably funded plans, the reduction will be the amount initially funded, adjusted for a pro rata share of fund gains or losses. The voluntary failure of a recipient to exercise a stock option is not considered a forfeiture. If the cost of a cash award for a group deferred compensation plan is later determined to be greater than the amount initially assigned due to an overestimate of forfeitures, the additional cost attributable to the incorrect estimate will be assigned to the cost accounting period in which the revised cost becomes known.

m. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-415.2 Illustrations **

The following illustrations are intended to supplement those in paragraph 415-60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the provisions of the standard.

a. **Problem.** The cost of a contractor's deferred compensation plan for a cash award is assigned to the cost accounting period in which the award is made. Under the provisions of the plan, the contractor has complete authority over forfeiture. If an employee is reassigned or laid off before he is eligible for benefits, the contractor may forfeit the employee's rights to the benefits.

Solution. Under CAS 415-50(a), one criterion for incurring an obligation is that the contractor cannot unilaterally avoid future payment. As a result of the contractor's discretionary control over the forfeiture provisions, this would not be considered a valid obligation. The cost should therefore be assigned to the year paid, not the year awarded.

b. **Problem.** The contractor's deferred compensation requires all cash awards to be increased by an eight percent interest factor.

Solution. The cost of future benefits assigned to the current accounting period should include interest cost calculated at eight percent compounded annually according to CAS 415-50(d)(1).

c. **Problem.** The contractor accounts for the cost of a cash award deferred compensation plan on a group basis, adjusted for an estimated four percent forfeiture

allowance. At the close of its fiscal year 1987, the actual cost of forfeitures amounted to only three percent because of a lower employee turnover than was originally anticipated.

Solution. The additional cost resulting from the overestimated forfeiture allowance should be charged to deferred compensations costs in fiscal year 1987.

d. **Problem.** The contractor has a deferred compensation plan that specifies that an employee receiving a cash award must remain with the company for three years after the award to receive benefits. On March 31, 1987 (fiscal year-end), the contractor awards $5,000 to an employee to be paid on March 31, 1990. According to the plan's requirement for irrevocable funding of future payments, the cost payable to the employee on March 31, 1990 was funded on March 31, 1987.

Solution. The entire amount irrevocably funded must be assigned to the fiscal year ending March 31, 1987 according to CAS 415-50(d)(6).

e. **Problem.** The circumstances are the same as for problem d. above except the employee voluntarily terminates his employment on May 30, 1987. On the date of termination, the fund has appreciated eight percent.

Solution. The amount irrevocably funded plus eight percent for the fund gain will be credited to deferred compensation costs in fiscal year-end March 31, 1988 as a forfeiture reduction.

f. **Problem.** The contractor maintains a self-insured retiree death benefit plan for which costs are recorded at the time the death benefit is paid. Questions have been raised as to whether these benefits should be considered deferred compensation subject to CAS 415 and whether the liability for currently retired employees should be accrued.

Solution. These benefits are not deferred compensation as contemplated in CAS 415. CAS 415-50(a)(3) requires a reasonably accurate measurement of future payments as a condition for accrual. Retiree death benefits could only be accrued by introducing mortality assumptions and this was not considered to fall within the meaning of "reasonable accuracy" as used in the standard.

8-416 Cost Accounting Standard 416 - Accounting for Insurance Cost **

CAS 416 provides criteria for the measurement of insurance costs, the assignment of such costs to cost accounting periods, and their allocation to cost objectives. The standard was effective July 10, 1979 and is applicable to a contractor on or after the start of its next accounting period beginning after the receipt of a CAS-covered contract.

8-416.1 General **

a. CAS 416 covers accounting for purchased insurance, self-insurance, and payments to a trustee of an insurance fund. When coverage is obtained through

purchase of insurance or payment into an insurance fund, the premium or payment normally should represent the insurance cost. Amounts representing coverage for more than one year should be assigned pro rata among the cost accounting periods covered by the policy term. When coverage is not obtained through purchased insurance or payment into an insurance fund, the contractor should follow a program of self-insurance in accordance with criteria in the standard. Self-insurance is defined as the assumption or retention of the risk of loss by a contractor, either voluntarily or involuntarily. Absence of insurance is regarded as one form of self-insurance. The contractor should make a self-insurance charge for each period for each type of self-insured risk based on an estimate of the projected average loss for that period. Insurance administration expenses that are material in relation to total insurance costs should be allocated on the same basis as the related costs.

b. FAR 31.205-19 makes the self-insurance provisions of CAS 416 applicable to all contracts, even contracts that are not CAS-covered or subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed insurance costs, where significant, comply with the provisions of CAS 416.

8-416.2 Guidance **

a. The standard requires the contractor to maintain records to substantiate the amounts of premiums, refunds, dividends, losses, and self-insurance charges. Records should also show the frequency, amount, and location of actual losses by major type of risk.

b. A contractor may need memorandum records to reflect material differences between insurance costs determined in accordance with CAS 416 and those includable in financial statements prepared in accordance with Financial Accounting Standards Board (FASB) Statement 5, Accounting for Contingencies. FASB Statement 5 does not permit an accrual for loss contingencies in a contractor's financial accounting records unless (1) an asset has been impaired or a liability incurred at the date of financial statements and (2) the amount can be reasonably estimated. Insurance costs determined in accordance with CAS 416 cannot be accrued in financial accounting records unless they represent purchased insurance, actual payment to a trustee, or the recognition of an actual loss. A self-insurance charge that only represents exposure to the risk of loss cannot be accrued.

c. Exposure to the risk of loss may differ significantly between defense and commercial operations and products. When risks differ significantly, defense and commercial insurance costs should be accumulated and allocated separately.

d. The audit of insurance premiums and payments to trustees should include:

(1) Examining insurance policies to determine the basis for establishing and adjusting premiums, and any provision for deposits and reserves.

(2) Determining whether the contractor controls or has a financial interest in the insurer. Purchase of insurance from a related organization may be a form of self-

insurance which should be audited in accordance with 8-416.2e.

(3) Examining the transactions in connection with an insurance reserve or fund in order to establish compliance with CAS 416-50(a)(iv) and (v).

(4) Evaluating direct allocations of premium costs to final cost objectives to detect possible noncompliance with CAS 402.

(5) Evaluating the assignment of premiums, refunds, and assessments to and among cost accounting periods.

e. CAS 416 does not establish minimum financial requirements for a contractor's self-insurance program. In order to assure that a contractor has adequate financial resources for a self-insurance program, FAR 31.205-19 requires contracting officer approval of a self-insurance program before the related costs are allowable. Auditors may be requested to furnish data in connection with the evaluation of the proposed self-insurance program. Self-insurance charges should be audited for compliance with CAS 416 and the approved program. The audit of self-insurance charges should include:

(1) Evaluating the contractor's overall self-insurance program and the adequacy of supporting records.

(2) Analyzing the nature, amount and pattern of actual insurance losses.

(3) Evaluating the contractor's method of estimating projected average loss from actual loss data.

(4) Comparing the self-insurance charge with the cost of purchased insurance when it is available.

f. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-416.3 Illustrations **

The following illustrations are intended to supplement those in paragraph 416-60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the standard's provisions.

a. **Problem.** Contractor X establishes an approved self-insurance program to cover employee group health plans beginning with its next accounting period. The contractor makes a self-insurance charge based on analysis of its actual loss experience over the prior 10-year period and an evaluation of anticipated conditions. The auditor determines that a well-known insurance company offers coverage at a cost materially lower than the self-insurance charge. The contractor refuses to purchase insurance because the insurance company is a subsidiary of a competitor and has a poor reputation.

Solution. The contractor's practice complies with CAS 416 even though purchased insurance is available at a lesser cost. Paragraph 5 of the supplemental information published with CAS 416 states that the limitation in CAS 416-50(a)(2)(i) is intended to apply only when the cost of comparable purchased insurance is used as a convenient method of estimating the projected average loss. The contractor's action is still subject to the test of reasonableness contained in FAR 31.201-3 as well as the allowability requirements of FAR 31.205-19, which disallows the difference between the cost of self-insurance and comparable purchased insurance (plus associated administrative expenses). The difference should be questioned if the purchased insurance is determined to be comparable.

b. **Problem.** Contractor Y proposes to discontinue its purchased insurance coverage and become self-insured without setting aside specific financial resources to cover future losses.

Solution. If the self-insurance charge is measured and allocated properly following the criteria in CAS 416-50(a)(2), the proposed practice complies with the standard regardless of the availability of specific financial resources to cover future losses. The same cost, however, may be unallowable under FAR 31.205-19 if the self-insurance program has not been approved by the CFAO.

8-417 Cost Accounting Standard 417 - Cost of Money as an Element of the Cost of Capital Assets Under Construction **

a. This standard establishes criteria for the measurement of the cost of money attributable to capital assets under construction, fabrication, or development as an element of the cost of those assets. The standard was effective December 15, 1980. It is applicable on or after the start of the next fiscal year beginning after receipt of a contract to which the standard applies.

b. FAR 31.205-10 makes CAS 417 applicable to all contracts, even contracts that are not CAS-covered or subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed cost of money costs, where significant, comply with the provisions of CAS 417.

8-417.1 General **

a. The standard's fundamental requirement provides that the cost of money applicable to the investment in tangible and intangible capital assets being constructed, fabricated, or developed for a contractor's own use, shall be included in the capitalized acquisition cost of such assets.

b. For each capital asset being constructed, fabricated, or developed, a representative investment amount shall be determined each cost accounting period, giving appropriate consideration to the rate at which costs of construction are incurred. The cost of money applicable to each asset shall be calculated using the applicable interest rates determined by the Secretary of the Treasury under Public Law 92-41, 85 Statute 97 (distributed semi-annually by Headquarters).

c. Cost of money shall not be capitalized for any period during which substantially all the activities necessary to get the asset ready for its intended use are discontinued unless such discontinuance arises out of causes beyond the control and without the fault or negligence of the contractor.

8-417.2 Guidance **

a. CAS 417 applies to both tangible and intangible assets being constructed, fabricated, or developed for a contractor's own use. Cost of money applicable to land should be added to the basis of the land rather than to the depreciable portion of the asset under construction. Land should not be included in the representative cost until the start of activity necessary to get it ready for its intended use, such as foundation development, landscaping, etc.

b. Cost of money should be computed only once for each cost accounting period that the asset is under construction based on the representative investment during the cost accounting period. Amounts capitalized as cost of money in one cost accounting period should be included in the representative investment for succeeding periods. Cost of money shall be calculated using the time-weighted interest rates determined by the Secretary of the Treasury. It is not necessary to enter the cost of money on the accounting records; however, the contractor should make a memorandum entry of the cost and maintain, in a manner that permits audit and verification, all relevant schedules, cost data, and other data necessary to support the entry.

c. The representative investment is the calculated amount considered invested by the contractor in the project to construct, fabricate, or develop the asset during the cost accounting period. In calculating the representative investment, consideration must be given to the rate of expenditure pattern of this investment. For example, if most of the investment was at the end of the cost accounting period, the representative investment calculation must reflect this fact.

d. The standard requires that if substantially all activity necessary to get the asset ready for its intended use is discontinued, cost of money shall not be capitalized for the period of discontinuance. However, when such discontinuance occurs beyond the control and without the fault or negligence of the contractor, the cost of money will continue to be capitalized. Therefore, the construction-in-progress accounts should be scrutinized to see if activity has ceased or dropped to a nominal amount. If this occurs, the circumstances should be examined. Brief interruptions and delays because of technical construction problems, labor disputes, inclement weather, shortage of material, etc. will not require discontinuance of capitalization of cost of money.

e. Assets purchased but not immediately put into service because they require installation are permitted to be included in the base for determining cost of money during the period of installation. However, caution should be taken to ensure that the activities necessary to get the asset ready for its intended use are not discontinued.

f. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-417.3 Illustrations **

The following illustration is intended to supplement those in paragraph 417-60 of the standard. It is to be used as a guide in determining whether a contractor's practices comply with the standard's provisions.

Problem. A contractor purchases a turbine for $1 million on January 1, 1986. The installation requires six months and is completed on June 3, 1986. The contractor capitalizes cost of money during the six-month period of installation stating that it was the CASB's intent that contractor investment be recognized through cost of money.

Solution. The contractor is entitled to capitalize cost of money during the six-month installation period. However, in the event that the activities necessary to get the asset ready for its intended use are discontinued, cost of money will not be capitalized for the period of discontinuance.

8-418 Cost Accounting Standard 418 - Allocation of Direct and Indirect Costs **

CAS 418 requires the consistent classification of costs as direct or indirect, establishes criteria for accumulating indirect costs in indirect cost pools, and provides guidance on allocating indirect cost pools. The standard was effective September 20, 1980. It is applicable on or after the start of the second fiscal year beginning after receipt of a contract to which the standard applies.

8-418.1 General **

The standard's fundamental requirements provide that:

(1) a business unit shall have a written statement of accounting policies and practices for classifying costs as direct or indirect which shall be consistently applied;

(2) indirect costs shall be accumulated in indirect cost pools which are homogeneous; and

(3) pooled costs shall be allocated to cost objectives in reasonable proportion to the beneficial or causal relationships of the pooled costs to cost objectives.

While the CAS and the FAR are similar with regard to the conceptual basis, the standard goes beyond the requirements of the FAR and provides more definitive guidance for allocation base selection.

8-418.2 Guidance **

a. The requirement for a written statement of accounting policies for classifying costs as direct or indirect is a critical aspect for assuring consistent implementation of this standard. If information disclosed by the contractor in "Part III, Direct vs. Indirect," Item 3.1.0, of the Disclosure Statement is insufficient to meet this requirement, the contractor should be requested to furnish additional detail.

b. Materiality is emphasized in evaluating any perceived need for change in cost

accounting practices. Materiality criteria are in 48 CFR 9903.305.

c. When a noncompliance condition is not reported because the amounts are not material, periodic evaluations are required to ascertain that the amounts remain immaterial. Noncompliant conditions that currently involve immaterial amounts but which may involve material amounts in the future should be reported to the CFAO in accordance with 8-302.7.

d. The creation of additional indirect cost pools should be required only if changes will result in materially different cost allocations.

e. Homogeneity of indirect cost pools is a significant requirement of the standard; however, a pool may be considered homogeneous if the separate allocation of costs of the dissimilar activities would not result in a materially different allocation of cost-to-cost objectives. Where there are no audit problems with the existing structure, it is not anticipated that CAS 418 would require further audit of the homogeneity of indirect cost pools. However, the allocation base for those pools must still be audited for compliance with the standard.

f. Where current problems regarding the allocation of direct and/or indirect costs do exist, CAS 418 provides authoritative support and criteria that may be helpful in formulating an acceptable solution.

g. Where the contractor is establishing new indirect cost pools, careful attention should be directed toward whether the pools meet the requirements of the standard. Audit considerations, applicable to conditions both before and after the establishment of a new pool, should include propriety of the allocation base, homogeneity of the cost pools, and materiality.

h. For purposes of selecting an allocation base, CAS 418 distinguishes between two types of indirect cost pools: (a) those that include a material amount of the costs of management and supervision of activities involving direct labor or direct material, and (b) those that do not.

(1) If an indirect cost pool contains a material amount of the costs of management or supervision of activities involving direct labor or direct material, the standard requires selecting an allocation base representative of the activity being supervised. Allocation bases are limited to direct labor hours or dollars, machine hours, units of production, or material costs, whichever is more likely to vary in proportion to the costs included in the cost pool being allocated.

(2) If an indirect cost pool does not contain material amounts of the costs of management or supervision of activities involving direct labor or direct material, the standard specifies criteria for selecting a base representing an appropriate measure of resource consumption. The standard establishes a hierarchy of acceptable representations of beneficial or causal relationships between the activities in the pool and benefiting cost objectives. The best representation is a measure of the resource consumption of the activities of the indirect cost pool. If consumption measures are

unavailable, or impractical to ascertain, the next best representation is a measure of the output of the activities of the indirect cost pool. If neither resources consumed nor output of the activities can be measured practically, the standard requires the use of a surrogate that varies in proportion to the services received to be used as a measure of resources consumed.

i. The allocation base used should result in an allocation to cost objectives in reasonable proportion to the beneficial or causal relationship of the pooled costs to cost objectives. Where the allocation base used is direct labor hours or dollars, all work accomplished, including hours worked in excess of 8 hours per day/40 hours per week by exempt employees or assigned costs, should be included as appropriate in the base for allocation of overhead costs. (See 6-410.3d.)

j. A special allocation of indirect costs is permitted if a particular final cost objective (e.g., contract) would receive a disproportionate allocation of indirect costs from an indirect cost pool. However, the allocation from the indirect cost pool to a particular final cost objective must be commensurate with the benefits received. The amount of special allocation must be removed from the indirect cost pool and the particular final cost objective's base costs must be removed for the base used to allocate the indirect cost pool. The CAS 418-50(f) provision is applicable to a particular final cost objective, rather than to classes of contracts or final cost objectives. It appears the intent is to use the special allocation provision in exceptional cases to resolve situations where equitable allocation cannot be achieved by normal methods. When a special allocation under CAS 418-50(f) is used, it must be described in the contractor's Disclosure Statement. Otherwise, the contractor would be in noncompliance for failure to follow its disclosed practices.

k. The criteria in CAS 407 should be applied to the use of average and preestablished direct labor rates. Material variances must be allocated annually to cost objectives in proportion to costs previously allocated.

l. Contractors are required to review preestablished rates for indirect costing at least annually, and revise the rates to reflect anticipated conditions. In addition, variances between actual or anticipated rates and preestablished rates must be disposed of at least annually, if material.

m. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-418.3 Illustrations **

The following illustrations are intended to supplement those in paragraph 418-60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the standard's provisions.

a. **Problem.** Contractor A proposes to establish an allocation method for the central reproduction cost center. The contractor wants to use the number of personnel in each department as the base for allocation of the cost center.

Solution. A central reproduction cost center does not contain a material amount of management and supervision of activities involving direct labor and direct material. Hence, the selection of a base is governed by CAS 418-50(e). Number of personnel is a surrogate for resource consumption that may be representative of the beneficial or causal relationship between the cost center and the benefiting cost objectives. However, acceptability of this base requires an analysis of the availability of more preferred bases:

(1) The best measure of resource consumption related to a central reproduction cost center may be equipment usage (hours). However, if the reproduction equipment does not have time meters and installation is not cost-effective, the use of such a base would be impractical.

(2) The next best representation of beneficial or causal relationship is output. A base consisting of the number of reproduced pages might be selected as an appropriate allocation measure of the output of the activities of the central reproduction cost center. However, if it is not practical to measure the number of pages reproduced for each requesting activity, a surrogate that varies in proportion to the services rendered may be used to measure the resources consumed.

(3) Such a surrogate could be the number of personnel in each department if past experience demonstrates that the number of requisitions varies in reasonable proportion to departmental population, thereby constituting a reasonable measure of the activity of the cost objectives receiving the service. Accordingly, the method adopted by the contractor could constitute an acceptable allocation basis, depending upon the circumstances.

b. **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.

c. **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.)

8-419 Reserved **

8-420 Cost Accounting Standard 420 - Accounting for Independent Research and Development Costs and Bid and Proposal Costs (IR&D and B&P) **

a. This standard provides criteria for the accumulation of IR&D/B&P costs and for the allocation of such costs to cost objectives. The standard was effective March 15, 1980 and must be followed as of the start of the second fiscal year beginning after the receipt of a CAS-covered contract. It does not apply to contractors subject to Office of Management and Budget Circular A-87, Cost Principles for State and Local Governments.

b. FAR 31.205-18 makes CAS 420 partially applicable to all contracts, even contracts that are not CAS-covered or subject only to modified CAS-coverage. Auditors should ensure that proposed or claimed IR&D/B&P costs, where significant, are in compliance with the provisions of CAS 420.

8-420.1 General **

The standard provides that IR&D/B&P costs are to be accumulated by project. Under specific conditions, costs of IR&D/B&P projects performed by a segment but benefiting more than one segment must be accumulated at the home office. Home office IR&D/B&P costs are to be allocated to segments through (1) allocation to specific segment(s) when beneficial or causal identification can be made, or (2) use of the CAS 403 residual expense allocation base. Special allocations are also permitted. IR&D/B&P costs accumulated at segments (including home office allocations and transfers from other segments) will be allocated to final cost objectives using the same base used for G&A expenses under CAS 410; however, special allocations are permitted.

8-420.2 Guidance **

a. The requirements for accumulation of IR&D/B&P costs by project and home office accumulation of IR&D/B&P projects benefiting more than one segment increase the need for maintaining close coordination between the CAC, CHOA, or GAC and auditors at operating segments. It is necessary that project identification be retained on costs transferred from a segment to a home office in order that appropriate allocations from the home office to all benefiting segments can be accomplished. The coordination process includes audits of advance agreement proposals and audits of incurred costs.

b. The standard provides that IR&D/B&P costs accumulated at the home office that can be identified with one or more specific segments shall be allocated to the specific segment(s). The standard does not specify the allocation method to be used when two or more (but not all) segments of an organization benefit from a specific IR&D/B&P project. In evaluating the method used, consideration must be given to whether the base will reasonably match cost distributions with the beneficial or causal relationships between the IR&D/B&P projects and the segments. The most straightforward base would consist of the same components used to allocate home office residual expenses. However, other potentially acceptable bases include total cost input and production labor hours or dollars. This listing is not all-inclusive and any base which reasonably matches cost with the beneficial or causal relationships between IR&D and B&P projects and benefiting segments would be acceptable under the provision of the standard.

c. The standard's prefatory comments indicate that a definition for B&P administrative costs was proposed by commentators, i.e., "B&P administrative costs, when not separately identified and classified as B&P costs in accordance with the contractor's normal accounting practice, are not considered B&P costs for the purpose of this standard." The CASB concluded that the proposed definition was not necessary because it dealt with allocation requirements that are addressed in CAS 420-50(a)(1). CAS 420-50(a)(1) states that IR&D/B&P project costs shall include "... costs, which if incurred in like circumstances for a final cost objective, would be treated as direct costs of that final cost objective "... B&P administrative costs, when not separately identified, may be excluded from the B&P pool if in accordance with the contractor's normal accounting practice. B&P administrative costs that are charged to an overhead (non-B&P) pool are not construed as being incurred "in like circumstances for a final cost objective." Therefore, the standard does not disturb the accounting treatment of B&P administrative costs under the FAR provisions.

d. Special allocations of IR&D/B&P costs are permitted from the home office to specific segments and from segment cost pools to specific final cost objectives provided the particular segment or final cost objective would receive a disproportionate allocation of the costs by using the prescribed allocation base. However, the special allocation must be commensurate with the benefits received. The provisions governing special allocations (CAS 420-50(e)(2) and 420.50(f)(2)) are applicable to occurrences which are exceptions to the contractor's normal operation, and are not intended for application to segment groups or classes of contracts or final costs objectives. As is the case with special allocations under CAS 403-40(c)(3) and 410-50(j), it appears the CASB's intent is to use the special allocation provisions to resolve specific situations where equitable allocation cannot be achieved by normal methods. When a special allocation under CAS 420-50(e)(2) or 420-50(f)(2) is used, it must be described in the contractor's disclosure statement.

e. The standard provides that any work performed by one segment for another segment shall not be treated as IR&D or B&P costs of the performing segment unless the work is part of an IR&D or B&P project of the performing segment (CAS 420-50(d)). If the work of the performing segment does not qualify as IR&D or B&P effort, the costs,

including business unit G&A expenses, are transferred directly to the receiving segment. Auditors at the performing segment will have the primary responsibility for evaluating the propriety of the accounting treatment of these interdivisional costs.

f. If noncompliances are found, the auditor must ascertain their significance and make appropriate recommendations as outlined in 8-302.7.

8-420.3 Illustrations **

The following illustrations are intended to supplement those in paragraph 420.60 of the standard. They are to be used as a guide in determining whether a contractor's practices comply with the standard.

a. **Problem.** A contractor currently uses a total cost input allocation base for G&A. In implementing CAS 420, this contractor proposes to exclude purchased services and major subcontracts from the allocation base for IR&D/B&P costs, citing the special allocation provisions of CAS 420-50(f)(2). The contractor points out that this practice, i.e., the exclusion of these costs from allocation of IR&D/B&P, has been accepted in previous years.

Solution. This practice would not be in compliance with the standard. Allocation of IR&D/B&P costs to final cost objectives is to be on the same allocation base used for G&A. Special allocations for classes of contracts (e.g., exclusions of major subcontracts from the base) are not appropriate under CAS 420-50(f)(2). The special allocation provision in CAS 420-50(f)(2) is limited to circumstances of a particular final cost objective.

b. **Problem.** Contractor H charges an engineering department's typing services for proposal preparation direct to B&P projects. General support typing services applicable to B&P and other departmental effort are not separately identified but are charged to an intermediate overhead pool and allocated to B&P projects, contract engineering projects, and other cost objectives based on labor hours.

Solution. The contractor's practice of charging general support B&P typing services to an intermediate overhead pool is in compliance with CAS 420-50(a). The B&P general support typing effort is not separately identified and classified as B&P cost and is not construed as being incurred "in like circumstances for a final cost objective." Therefore, B&P general support typing effort is allocable to an overhead account, providing the allocation practice is otherwise considered acceptable and equitable.

c. **Problem.** Company R has eight segments. Segment A performs IR&D projects that have technical application to it and two other segments. Technical application is not identifiable to the remaining five segments. The cost of those projects performed by Segment A is transferred to the home office and allocated in equal parts (one-third) to the three segments.

Solution. Company R is in compliance with CAS 420.50(e)(1) and 420.50(f)(1) providing the technical applications received by the three segments are equal. If an

allocation of equal shares does not reflect the participation in technical applications, other allocation bases that could be considered include total cost input (for the three segments) or a base consisting of the same components used to allocate home office residual expenses.

8-500 Section 5 - Audit of Cost Impact Proposals Submitted Pursuant to the Cost Accounting Standards (CAS) **

8-501 Introduction **

This section contains guidance on the audit of contractor cost impact proposals that are submitted in accordance with the price adjustment provisions of the CAS clauses.

8-502 General - Cost Impact Proposals **

8-502.1 CAS Clause Requiring Price Adjustments **

Paragraph (a)(5) of the CAS clause (FAR 52.230-2) requires that contractors agree to contract and subcontract price adjustments, with interest, if increased costs to the Government result from their failure to comply with CAS or to follow consistently their disclosed cost accounting practices in estimating, accumulating and reporting costs on contracts and subcontracts containing the CAS clause. The CAS clause provides in paragraph (a)(4)(i) for an equitable price adjustment when a change from one accounting practice to another is required to comply with a CAS that subsequently becomes applicable to a contract or subcontract, or is necessary for the contractor to remain in compliance (required change). Paragraph (a)(4)(iii) also provides for an equitable price adjustment when the cognizant Federal agency official (CFAO) determines that a change from one compliant practice to another is desirable and not detrimental to the Government (desirable change). However, paragraph (a)(4)(ii) provides that adjustments resulting from a change which is a compliant change, but which the CFAO has not deemed desirable, may not result in increased costs to the Government in the aggregate (unilateral change).

8-502.2 FAR Requirement for Submission of Cost Impact Proposal **

a. After a CFAO determines that costs paid by the Government may be materially affected by a cost accounting practice change or CAS noncompliance, FAR 52.230-6(c) requires that contractors submit cost impact proposals in the following instances:

(1) Required Accounting Practice Changes. A required change arises when the CFAO determines that a contractor is required to make a change in cost accounting practices to comply prospectively with a new or modified cost accounting standard. A required change also arises for prospective changes from one compliant cost accounting practice (disclosed or established) to another compliant practice when the planned change is necessary for the contractor to remain in compliance with CAS (see 48 CFR 9903.201-6(a)).

An example of a prospective accounting practice change necessary to remain in

compliance with CAS may arise when a labor-intensive contractor receives several material-intensive contracts. The contractor's total cost input G&A allocation base would cause disproportionate allocations of G&A expense to the material-intensive contracts. Therefore, in order to remain in compliance with CAS 410, the contractor changes to a value-added G&A allocation base. Prior to award of these contracts, the contractor was in compliance with CAS 410. In order to remain in compliance with CAS 410, the contractor must change to a value-added allocation base.

The cost impact proposal for a required change provides the CFAO with a basis for equitable adjustment to CAS-covered contracts and subcontracts existing on the effective date of the changed practice in accordance with FAR 52.230-2(a)(4)(i), and may result in either price or cost increases or decreases.

(2) Unilateral Accounting Practice Changes. A unilateral change is a change from one compliant practice to another compliant practice that a contractor elects to make, but that the CFAO has not determined to be desirable (see 48 CFR 9903.201-6(b)). A unilateral change is subject to the provisions of FAR 52.230-2(a)(4)(ii). Because the change is neither required nor determined to be desirable, no increased costs may be paid by the Government on affected CAS-covered contracts and subcontracts as a result of the unilateral change. Unilateral changes are applied prospectively in accordance with FAR 52.230-2(a)(2). The cost impact proposal for a unilateral change provides the CFAO with a basis for determining the extent of increased costs, if any, to the Government in the aggregate on affected CAS-covered contracts and subcontracts as a result of the unilateral change. The cost impact proposal also provides the CFAO with a basis for determining the appropriate settlement alternative for the recovery of increased costs.

(3) Desirable Accounting Practice Changes. A desirable change occurs when the contractor elects to make a change from one compliant practice to another, and the CFAO determines that the change is desirable and not detrimental to the Government (see 48 CFR 9903.201-6(c)). A change may be considered desirable even though costs increase on existing CAS-covered contracts and subcontracts. If the parties agree, such changes may include early implementation of new CAS. The cost impact proposal for a desirable change provides the CFAO with a basis for equitable adjustments to affected CAS-covered contracts and subcontracts in accordance with FAR 52.230-2(a)(4)(iii), and may result in either increased or decreased costs.

Changes to 48 CFR 9903.201-6(c), effective June 14, 2000, provide that, for accounting practice changes that the CFAO has determined are desirable, the cost impact of associated management actions that have an impact on contract and subcontract costs should be considered. This means that there may be other events occurring at the same time as the accounting practice change that should be considered to equitably resolve the overall cost impact. Examples of "associated management actions" include internal restructuring activities. In order to consider the impact of this management action in the cost impact calculation, the cost impact of the changed practices should be calculated as the difference between the former accounting practice using the cost level without the effect of the management action, and the new

accounting practice using the cost estimate with the effect of the management action as reflected in the new forward pricing rates.

(4) Noncompliances. Noncompliances arise when the contractor fails to comply with an applicable CAS or to consistently follow any disclosed or established cost accounting practice. FAR 52.230-2(a)(5), 52.230-3(a)(4), and 52.230-4 implement the statutory requirement that the Government shall not pay increased costs as a result of a CAS noncompliance. 48 CFR 9903.306 further explains the statutory requirements. These FAR provisions also require that the Government recover interest from the time the payment of increased costs was made by the Government until the time the adjustment is effected. FAR 32.604(b)(4)(i) provides that interest on increased costs paid by the Government is computed using the annual underpayment rate established under 26 U.S.C. 6621(a)(2) of the 1986 Internal Revenue Code. This is the same interest rate used to compute interest when defective pricing is found (see 14-124).

b. The cost impact proposal must be submitted within 60 days (or other mutually agreed-upon date) after the proposed change is determined adequate and compliant, the date of the contractor's agreement with the initial finding of noncompliance, or the date the contractor is notified by the CFAO of a determination of noncompliance.

c. An integral part of the cost impact proposal is the list of CAS-covered contracts and subcontracts that are, or will be, affected by the change or noncompliance. To comply with the requirements of FAR 52.230-6, contractors should maintain a system for identifying accurately and completely all contracts and subcontracts containing the CAS clause. The auditor should evaluate the adequacy of contractors' procedures and report to the CFAO if the contractor does not maintain the required records. Once the contractor has established such procedures, the auditor should perform limited testing of contract and subcontract listings on specific cost impact proposals to assure the continuing effectiveness of the contractor's system. Report exceptions in the cost affect proposal examination audit report. For smaller contractors, test the listing of CAS-covered contracts and subcontracts included in specific cost impact proposals against FAO files of active cost reimbursable contracts and subcontracts, and listings of CAS-covered fixed price procurement actions available within DoD. (See CAS Working Group Paper 77-17.)

8-502.3 Accounting Practice Changes Related to External Restructuring **

Often cost accounting practice changes occur in conjunction with organizational changes. Under 48 CFR 9903.201-8, effective June 14, 2000, the cost impact process does not apply to compliant cost accounting practice changes directly associated with external restructuring activities that are subject to and meet the requirements of 10 U.S.C. 2325. This statute established the allowability requirements and two-to-one savings requirements for external restructures, implemented by DFARS 231.205-70. This type of restructuring activity is described in Selected Areas of Cost Guidebook, Chapter 63. One of the requirements associated with this type of restructure is that savings for DoD exceed the costs allowed by a factor of two-to-one, or that savings exceed costs and the Secretary of Defense determines that the restructuring activities

will result in the preservation of a critical capability that might otherwise be lost to the Department. Since the Government is achieving overall cost savings in this type of restructuring effort, the CASB decided to exempt changes to cost accounting practices directly associated with external restructuring activities from the cost impact process.

8-502.4 Cost Impact Proposal Data Requirements **

FAR 52.230-6 requires cost impact proposals to be prepared in the manner and form (level of detail) prescribed by the CFAO (usually with audit advice). Any cost impact proposal format specified by the CFAO should provide the same approximate result as if the cost impact for each CAS-covered contract was calculated individually. FAR 52.230-6 requires that cost impact proposals be prepared in sufficient detail to permit the evaluation, determination, and negotiation of the cost impact. The basic required data include (i) identification of each CAS-covered contract and subcontract and the cost impact (including cost, profit/fee, and price/amount) on each CAS-covered contract and subcontract or, if agreed to by the CFAO, a representative selection of contracts and subcontracts that will give the same approximate result as if the cost impact on each CAS-covered contract and subcontract was calculated individually and (ii) grouping the CAS-covered contracts and subcontracts by contract type (e.g., FFP, FPI, CPFF, CPIF) and by the various Departments/agencies (e.g., Army, Navy, Air Force, NASA, DOE).

8-502.5 Adequacy of Cost Impact Proposals **

Contractors are required to submit proposals that reflect the cost impact of changes made to their disclosed or established cost accounting practices, or noncompliances with CAS or disclosed accounting practices.

a. Auditors should work closely with the CFAO to encourage contractors to submit timely and adequate cost impact proposals. If an adequate cost impact proposal is not submitted by a stipulated date, it may be necessary for the CFAO to exercise the withhold provisions of FAR 30.604(i) (see also FAR 52.230-6(j)).

b. The auditor should initially evaluate the cost impact proposal for adequacy of content and method of presentation. If inadequately prepared, return the proposal to the contractor through the CFAO with the deficiencies specifically identified.

c. The auditor should not return the cost impact proposal to the contractor solely because a certificate of current cost or pricing data did not accompany the proposal. Contract modifications made under the CAS clause are subject to FAR 15.403-4, which requires certified cost or pricing data and which incorporates the certification requirement at FAR 15.406-2. This requirement applies to the individual modification, not to the cost impact proposal itself. The timing of the certificate is as of the date of agreement on price. Therefore, no certificate is required at the time of submission of the cost impact proposal. It is the CFAO's responsibility to obtain a certificate of current cost or pricing data before completing the contract modification(s).

d. For defense contracts, a certification is required per DFARS 243.204-70 and

252.243-7002 at the time of submission of the cost impact proposal if the contractor requests an equitable adjustment that exceeds the simplified acquisition threshold ($150,000) to any defense contract as a result of required or desirable cost accounting practice changes under the CAS clause. The $150,000 threshold applies to equitable adjustment on a contract-by-contract basis, not to the cost impact proposal itself.

8-502.6 Audit of Cost Impact Proposals **

FAR 30.601(c) provides that the CFAO shall request and consider the advice of the auditor when performing CAS Administration, which would include audits of cost impact proposals. The purpose of the audit is to assist the CFAO in negotiating contract price adjustments on all affected CAS-covered contracts and subcontracts. Audit advice should be provided considering materiality and risk criteria. Auditors should consider an array of audit procedures as appropriate during the audit of cost impact proposals, including statistical and judgmental selection, risk assessment, past experience, discussion with contractor personnel, and comparison with previous cost estimates. The results of these evaluations will be reported to the CFAO responsible for negotiating the price adjustment.

8-502.7 Inclusion of Implementation Costs **

Implementation costs may be included in cost impact proposals only to the extent they are a part of appropriate indirect expense pools and allocated in accordance with the contractor's normal accounting practices. (See CAS Working Group Paper 76-5.)

8-502.8 Noncompliance with FAR Part 31 **

The CAS clause, FAR 52.230-2, does not provide for price adjustment for noncompliance with FAR Part 31. Therefore, if a contractor fails to follow FAR, cost disapprovals will be processed in accordance with existing procedures. (See 8-302.8).

8-503 Guidance on Evaluation of Cost Impact Proposals **

8-503.1 Five-Step Process to Calculate Cost Impact **

Auditors should use the five-step process described below to evaluate cost impact proposals and assist the CFAO in resolving cost impacts resulting from cost accounting practice changes and CAS noncompliances. Auditors should use only steps a. through c. of the process to evaluate cost impacts resulting from required and desirable cost accounting practice changes that are subject to equitable adjustment. Auditors should use all steps to determine increased or decreased costs to the Government in the aggregate resulting from unilateral cost accounting practice changes and CAS noncompliances. Steps a. and b. involve ascertaining the impact of the accounting practice change or noncompliance on cost estimates and accumulations (i.e., cost measurement, assignment, and allocation). Step c. translates the resulting cost estimation/accumulation impact into its effect on contract and subcontract prices. Step d. calculates increased or decreased costs paid by the Government in the aggregate, using the CAS Board's (CASB's) definitions of increased costs paid. Finally, step e. addresses settlement alternatives available to the CFAO, who is responsible for

administration of CAS matters.

a. Compute the increased/decreased cost estimates and/or accumulations for CAS-covered contracts and subcontracts.

(1) Accounting practice changes. The increase or decrease in cost accumulations is the difference between the estimated cost to complete (ETC) using the old accounting practice and the ETC using the new accounting practice. It is prospective from the effective date of the change and continues through the end of the period of performance of each affected contract and subcontract.

(2) Noncompliance in cost accumulation. The increase or decrease in cost accumulations is the difference between costs accumulated using the noncompliant practice and costs that would have been accumulated if a compliant practice had been used. The cost accumulations affect only flexibly-priced contracts and subcontracts, and only for the period during which the contractor accumulated costs in a noncompliant manner.

(3) Noncompliance in cost estimating. The increase or decrease in cost estimates is the difference between the costs estimated using the noncompliant practice and the costs that would have been estimated if the contracts and subcontracts had been priced using a compliant practice. Estimating noncompliances affect fixed price contracts and subcontracts, and fixed, target, and incentive fees on flexibly priced contracts and subcontracts. Estimating noncompliances affect the entire period of performance for each affected contract and subcontract.

b. Combine the increased/decreased cost estimates and/or accumulations within each contract group. In this step, we consider two groups of CAS-covered contracts - flexibly priced and fixed price (FP).

(1) Flexibly priced contracts include cost-reimbursement contracts/subcontracts and other contracts/subcontracts subject to adjustment based on actual costs incurred; incentive contracts/subcontracts where the price may be adjusted based on actual costs incurred; and the flexibly priced portions of time-and-materials contracts/subcontracts.

(2) FP contracts include those contracts and subcontracts where the price does not vary based on the contractor's actual costs, including the fixed hourly rate portion of time-and-materials and labor-hour contracts and subcontracts.

(3) In this step, the increased/decreased cost estimates and/or accumulations developed in a. above are combined within each contract group. Combining the increased/decreased cost estimates and/or accumulations within a contract group is done for administrative convenience so the CFAO may adjust a few contracts, rather than all contracts.

(4) The impact on cost estimates and/or accumulations is combined only within a contract group, not between contract groups, for the following reasons:

(a) Increased costs paid by the Government on flexibly priced contracts and subcontracts result from increased cost accumulations arising from cost accounting practice changes or accumulation noncompliances. Increased costs paid by the Government on FP contracts and subcontracts result from decreased cost accumulations resulting from cost accounting practice changes, or from higher costs estimated by using noncompliant practices (48 CFR 9903.306). These differences make it improper and mathematically unworkable to simply combine the cost accumulations across contract groups.

(b) Combining the increase/decrease in cost estimates and/or accumulations between contract groups could result in inequitable results. For instance, assume cost accumulations on FFP contracts and subcontracts decreased by a net $200, while cost accumulations on CPFF contracts and subcontracts increased by a net $200. If the cost accumulations are combined mathematically between contract groups, the Government would recover nothing, which is not equitable since increased costs paid by the Government occurred on both FFP and CPFF contracts and subcontracts.

(c) Combining the increase/decrease in cost estimates and/or accumulations between contract groups presumes that cost shifts occur only within CAS-covered contracts and subcontracts. Cost shifts also affect existing non-CAS-covered contracts and subcontracts, and/or future awards. Future awards are affected because the CAS-covered contracts and subcontracts usually have different periods of performance. In the case of an estimating noncompliance, the periods of performance for the individual affected CAS-covered FP contracts and subcontracts cover different cost accounting periods. Therefore, cost shifts also affect existing non-CAS-covered and/or future contracts not included in the cost impact proposal.

c. Determine the increased/decreased cost paid by the Government for each contract group, using the net impact on cost estimates, accumulations and profits/fees.

(1) Increased costs paid by the Government.

(a) Flexibly priced contracts. Increased costs paid by the Government occur when more costs are accumulated on flexibly priced contracts and subcontracts as a result of an accounting practice change or cost accumulation noncompliance.

(b) FP contracts. Increased costs paid by the Government occur when fewer costs are accumulated on FP contracts and subcontracts as a result of an accounting practice change or when the negotiated contract or subcontract price is higher as a result of a cost estimate using a noncompliant practice.

(c) Profit/fee. Increased costs paid by the Government also occur when more profit/fee was negotiated than would have been contemplated by the contracting parties if the cost estimate had been based on changed or compliant practices. Accounting practice changes and estimating noncompliances affect fixed, target, and incentive fees. Accumulation noncompliances also affect incentive fees. Profit/fee that

is not based on estimated costs (e.g., award fees) is generally not subject to adjustment.

(2) Decreased costs paid by the Government. Decreased costs paid by the Government are not defined by the CASB, although the CAS statute presumes that there can be decreased costs paid by the Government, since it provides for adjustments to remove only increased costs paid in the aggregate. We interpret "decreased costs" to be the conceptual opposite of the CASB's definition of "increased costs."

(a) Flexibly priced contracts. Decreased costs paid by the Government occur when fewer costs are accumulated on flexibly priced contracts and subcontracts as a result of an accounting practice change or noncompliance in cost accumulation. This occurs automatically as fewer costs are recorded on the contracts and subcontracts.

(b) FP contracts. Decreased costs paid by the Government occur when more costs are accumulated on FP contracts and subcontracts as a result of an accounting practice change or when the negotiated contract or subcontract price is lower as a result of estimating using a noncompliant practice.

(c) Profit/fee. Decreased costs paid by the Government also occur when less profit/fee was negotiated than would have been contemplated by the contracting parties if the cost estimate had been based on compliant or changed practices. Cost accounting practice changes and estimating noncompliances affect fixed, target, and incentive fees. Accumulation noncompliances also affect incentive fees. Profit/fee that is not based on estimated costs (e.g., award fees) is generally not subject to adjustment.

The results of this step are used as the basis for negotiation of equitable adjustments for required and desirable accounting practice changes. In these cases, it is not necessary to determine increased costs in the aggregate and steps d. and e. need not be performed.

d. Determine the increased costs paid by the Government in the aggregate by combining across contract groups the increased/decreased costs paid by the Government for both contract groups, as determined in step c. Combining the increased/decreased costs paid by the Government between the two contract groups to determine increased costs in the aggregate is consistent with CAS regulations (see 48 CFR 9903.306(e)). However, there may be rare instances when combining the increased/decreased costs paid by the government across the two contract groups produces inequitable results. In these instances, auditors should apply another aggregation method to determine the increased costs in the aggregate. Increased costs in the aggregate represent the total amount owed to and to be recovered by the Government as a result of the unilateral change or noncompliance. Should there be decreased costs in the aggregate resulting from unilateral changes or noncompliances, there will be no recovery by the contractor.

e. Settlement Alternatives. It is the CFAO's responsibility to administer CAS, including the resolution of cost impacts. Once the aggregate increased costs paid by the Government as a result of unilateral changes and noncompliances are determined, it is the CFAO's responsibility to work toward a settlement that precludes payment by the Government of this amount. There are a number of settlement alternatives available to the CFAO to resolve cost impacts. The auditor should assist the CFAO as necessary in settlement of these issues. Some of the options for recovery of increased costs include:

(1) Contract adjustment. Adjustments may be made to all contracts and subcontracts, or limited to certain contracts, and may include reduced cost allowances on flexibly priced contracts, downward adjustment of contract prices, target costs, ceilings, and profit/fee.

(2) Indirect rate adjustments. Any adjustment to indirect cost pools should be designed to ensure the recovery of the total amount of the aggregate increased costs paid by the Government (i.e., the impact on all CAS-covered contracts and subcontracts regardless of contract type). Indirect rate adjustments should be made only to final indirect rates, rather than on forward pricing rates, to ensure that the Government recovers the full amount it is owed.

(3) Cash payment. This option may be appropriate when the amount of increased costs in the aggregate is small or when writing a check is less burdensome than making contract or indirect rate adjustments.

8-503.2 Interest **

FAR 52.230-2(a)(5), 52.230-3(a)(4), 52.230-4 and 52.230-5(a)(5) provide that the Government will also recover interest on overpayments made to the contractor, including increased costs paid due to CAS noncompliances. Interest will be compounded daily from the date payment is made by the United States until the date the adjustment is effected, using the annual rate established under section 26 U.S.C. 6621 of the 1986 Internal Revenue Code. This is the same interest rate used when defective pricing is found (see 14-124). The auditor should be alert to the potential significance of interest and offer to provide assistance to the CFAO in calculating interest due to the Government once the CFAO makes the final determination on the cost impact proposal audit report. The auditor should calculate daily compound interest using the CAS Noncompliance Cost Impact Interest Calculator located on DCAA's Intranet under DCAA Software Applications Library. Calculating daily compound interest is in accordance with the Unites States Court of Appeals for the Federal Circuit (CAFC) ruling dated September 14, 2009; Case No. 2008-1543.

8-503.3 Offsetting Cost Impacts **

FAR 30.606 specifically states that cost impacts may not be combined except under limited circumstances provided at FAR 30.606(a)(3).

8-504 Failure to Submit Cost Impact Proposals **

a. FAR 52.230-6(j) provides that if the contractor fails to submit a cost impact proposal, FAR provides that the CFAO, with the assistance of the auditor, shall estimate the cost impact on contracts and subcontracts containing the CAS clause. The auditor should base the estimate, as much as possible, on readily available data. The auditor's objective is not to relieve the contractor of its responsibility for preparing the proposal, but merely to provide sufficient information upon which the CFAO can base a decision to withhold payment. Once the CFAO has made the decision to withhold payment, the burden of proof should rest with the contractor to demonstrate, through a detailed analysis, the cost impact on each CAS-covered contracts and subcontracts, rather than to debate the merits of the Government estimate. (This is similar to the procedure established in FAR 49.109-7 for termination settlement by unilateral determination.) The associated audit report should include:

(1) the scope of the audit,

(2) a description of the circumstances relating to the contractor's failure to submit a cost impact proposal, and

(3) the basis used to develop the estimate.

If the auditor is unable to provide the estimate, the report should give the reasons and identify the data needed to comply with the CFAO's request.

b. The FAR withhold provisions provide that the CFAO may withhold an amount not to exceed 10 percent of each subsequent payment request related to the contractor's CAS covered prime contracts which contain the appropriate withholding provisions until the cost impact proposal has been furnished. In these situations, the estimate of the cost impact will be used by the CFAO to determine a maximum amount that should be withheld. Although not specifically provided for in the FAR, the auditor should recommend to the CFAO that withholding begin immediately and continue while the estimate of the cost impact is being developed.

8-505 Conferences and Reports on Audits-Cost Impact Proposals **

a. See 4-300 for guidance on entrance, interim, and exit conferences with the contractor. When appropriate (e.g., when there are numerous CAS-covered contracts and subcontracts, a series of changes, or complicated changes), the contractor and the Government should discuss and agree in advance on the manner and form of a cost impact proposal in order to ease the administrative process.

b. After completing each cost impact proposal audit, prepare and distribute a report using the guidance in 10-809.

8-506 Coordination **

Extensive coordination will be required when the adjustments are for changes to or failure to follow home office accounting practices. Such adjustments will affect all CAS-covered contracts and subcontracts at all organizational units that receive cost

allocations from the home office. It is expected, therefore, that the CAC, the CHOA, the GAC, and/or the auditor cognizant of an intermediate management organization will furnish the auditors cognizant of all segments with the results of the audit on distributing home office expenses, so that the proposed effect on contracts and subcontracts at the receiving segments can be verified. The cognizant auditors would then report back to the CAC, CHOA, or GAC who would issue a consolidated report to the CFAO responsible for the home office.