

## SELECTED AREAS OF COST

### Chapter 37 – Joint Ventures and Teaming Arrangements

#### **Authoritative Sources**

#### [Cost Accounting Standards](#)

FAR Subpart 9.6 Contractor Team Arrangements

FASB ASC 323 Investments - Equity Method and Joint Ventures

FASB ASC 325 Investments - Other

The form of business organization chosen by the contractor to carry on its business or to bid on Government contracts significantly affects contractor costs and income taxes. Eligibility for award of a Government contract may be directly linked to the form of business organization under which a contractor elects to bid.

#### **General Audit Guidelines**

The form of business organization will have a significant bearing on determining the allowability and allocability of costs incurred under Government contracts.

Therefore, in reviewing a contractor's business organization, the auditor must consider the related business circumstances and the contractor's compliance with FAR, CAS, and generally accepted accounting principles.

This chapter addresses the following topics:

- 37-1 Definitions and Characteristics
- 37-2 Form and Substance
- 37-3 Accounting Considerations
- 37-4 FAR and CAS Considerations

### **37-1 Definitions and Characteristics**

#### **Corporation**

A business organization of one or more persons, partnerships, associations, or corporations chartered by the state for the purpose of conducting profit making endeavors with the objective of dividing the gains. A corporation is a separate legal entity with the following usual characteristics:

- continuity of existence,
- centralized management,
- liability limited to corporate assets, and

- free transferability of interest.

A corporation may perform any business action that a natural person can perform.

### **Joint Venture**

An enterprise owned and operated by two or more businesses or individuals as a separate entity (not a subsidiary) for the mutual benefit of the members of the group. Joint ventures possess the characteristics of [joint control](#). Joint ventures can be either incorporated or unincorporated and may be either populated or unpopulated. A populated joint venture has actual employees, whereas, an unpopulated joint venture is essentially a shell organization with no or few employees. In an unpopulated joint venture, the work is subcontracted to the venture partners for actual contract performance.

An incorporated joint venture involves the issuance of stock and is most common on large construction type contracts. These joint ventures possess the typical characteristics of a corporation. It is a separate legal entity and acts as a contracting party. An unincorporated joint venture can be a partnership or teaming arrangement between two or more corporations usually involved in large research and development and/or major weapons systems contracts. Usually in this type of joint venture, the joint venture is the contracting entity and is designated to act as the prime contractor and most often has:

- few or no employees hired and paid by the joint venture;
- little or no assets or separate facilities;
- no separate financial statements; and
- little or no G&A, B&P, or material handling expenses.

The venturing organizations usually specify in writing the terms of the formation, operation, and dissolution of the venture. Furthermore, under the typical arrangement:

- each investor participates, directly or indirectly, in the overall management of the joint venture (i.e., joint ventures usually have an interest or relationship in the venture other than as passive investors);
- significant influence of each of the investors is presumed to be present; and
- one investor does not have control by direct or indirect ownership of a majority voting interest (otherwise the venture is likely to be a subsidiary of the controlling investor).

## **Teaming Arrangement**

An arrangement between two or more companies, either as a partnership or joint venture, to perform on a specific contract. The team itself may be designated to act as the prime contractor; or one of the team members may be designated to act as the prime contractor, and the other member(s) designated to act as subcontractors (see FAR Subpart 9.6). When the characteristics of joint control are evident, then the teaming arrangement is a joint venture. When these characteristics are not present then the arrangement may more closely resemble that of a prime contractor/subcontractor.

## **Partnership**

An ordinary partnership occurs when two or more entities (persons) combine capital and/or services to carry on a business for profit. From a legal standpoint, it is considered a group of separate persons rather than as a single entity.

## **Cooperative Research Consortia**

A cooperative research consortium is a partnership, joint venture, or corporation organized pursuant to the 1984 National Cooperative Research Act. Research consortiums involve collaborations among competitors and are usually formed to explore specific research areas. Unlike other business entities discussed in this section, cooperative research consortiums are not formed to bid on Government contracts. See Chapter 33, Independent Research & Development and Bid & Proposal Costs for additional guidance on cooperative research consortiums.

## **Subsidiary**

An entity controlled, directly or indirectly, by another entity. Control is usually conditioned upon ownership of a majority of the outstanding voting stock. It may also exist; however, with less than a majority of the outstanding voting stock under certain conditions, e.g., there is a contract lease, agreement with other stockholders, or court decree.

## **Business Unit/Segment**

FAR and CAS use the same definition for the terms [segment](#) and [business unit](#). When reviewing the accounting aspects of a contractor's business organization, the identification of the organization as a segment or business unit is important for the following reasons:

- CAS consistently uses the terms "segment" and "business unit" to present its accounting guidance on business organizations;

- various sections of the Accounting Standards Codification, such as those dealing with consolidated reporting, also use the term "[business segment](#)" to present GAAP that applies to business organizations in general; and
- [entities that do not satisfy the basic criteria for a segment or business unit are actually an undivided part of a contractor business unit.](#)

### 37-2 Form and Substance

The form and substance of a contractor's business organization can significantly influence the allowability and allocability of costs incurred under Government contracts. Normally no one factor should be the sole determinant of whether the relationship is a joint venture or more closely resembles a prime contractor/subcontractor relationship. The allocation of costs should reflect the causal/beneficial relationships between and among the venture partners and other segments/home offices of the contractor.

The audit team should determine not only the form of the [business organization](#), but the actual relationship (substance) between the venturing contractors. In determining the form and substance, the auditor should consider the following:

- Is the joint venture a business segment?
- What is the actual relationship between the venturing organizations?
- What is the purpose of the joint venture (i.e., is it engaged for a single purpose for a specific business objective)?
- Is the joint venture cost accounting and tax treatment consistent with the form and substance of the business organization?
- Does the joint venture accounting result in equitable cost allocations between and among the business organizations/segments?
- Does the joint venture have a cost impact on the existing contracts of the venturing/parent organizations, and if so, has a change in cost accounting practices occurred?

In making this determination, the audit team should:

- Review the joint venture agreement(s). FAR 9.603 requires contractor joint ventures and teaming arrangements to identify and disclose the arrangements in an offer or, for arrangements entered into after submission of an offer, before the arrangement becomes effective. This is normally done in a written agreement between the participating contractors. An agreement will normally contain and/or explain:
  - the name of the venture;
  - the customer and solicitation number;
  - the names of the participants;

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- any limitations on the powers and rights of the participants;
- the contributions that each participant is required to make with regard to the venture's capital, personnel, proposal preparation, etc.;
- anticipated subcontracts;
- funding requirements;
- responsibilities for record keeping and for the preparation of reports and invoices;
- the designated management;
- limitation of liabilities;
- term of venture and dissolution agreements;
- responsibilities for and restrictions on royalties, patents, copyrights, and property rights arising from venture operations;
- the resolution of disputes among the venturers;
- covenants on how litigation costs will be borne by the participants;
- which state's laws will govern the venture;
- the filings or disclosures required by the state, FAR, etc.;
- any technology transfer agreements; and
- any cost/profit sharing agreements.

The written agreement will help determine the management, financial, and technical responsibilities of each member of the venture.

- Review the joint venture/teaming arrangement organization chart(s) and policies and procedures. This information can be useful in determining if the characteristics of joint control and management are present or if one contractor seems to possess the control and management characteristics of a prime contract.
- Ascertain each venturer's responsibility for the financial and technical management of the joint venture. Determine the composition of the joint venture management team, the location of the joint venture program office, the procedures for preparing the joint venture financial statements, tax returns, and Government billings and technical reports. Also, review each venturer's responsibility and role in the preparation of the joint venture proposal. Ascertain each venturer's responsibilities for outside subcontractor selection and material purchasing. The composition of the key personnel to the joint venture should also be analyzed. When considered together this information will help determine the actual relationship between the venturers. It will also help determine if one venturer exercises control over the joint venture.

- Review the composition of the joint venture or teaming arrangement capital and equity to help determine if one of the venturers exercises ownership control. Analyze any cost and revenue sharing agreements and asset contributions.
- Review the technical relationship between the venturers by reviewing the written agreement, any technical exchange agreements, the cost and technical proposals, the contract and/or subcontract statements of work, and other relevant documentation. Determine the assignment of technical responsibilities to each venturer, the integration of work products between the venturers, and the technical areas of expertise of each venturer. The responsibilities of each organization for technical interface with the Government can also help determine the technical relationship between the venturers.
- Review the joint venture or teaming arrangement tax returns and supporting records to determine, confirm, or gain additional insight into the type and nature of the contracting entity. Tax information can answer questions on ownership and control and on whether a given organization exists as a separate legal business entity or as a component of a contractor's existing business entity. When reviewing a joint venture or teaming arrangement that may or should be treated as a partnership for tax purposes, request Schedules K and K-1, supporting Partnership Return Form 1065. These schedules address the apportionment of income, credits, deductions, etc. to the individual partners (i.e., joint venturers/team members). They also identify the individual partners and contain other information relating to the assessment of costs, degree of control, ownership of capital, percentages of profit and loss sharing, and credits.
- Discuss the joint venture/teaming arrangement with the cognizant DCAA offices for the other venturing contractors to help ensure consistent audit treatment. Coordinate with the other cognizant DCAA offices to establish responsibilities for audits of forward pricing proposals, public vouchers, progress payments, etc., to request appropriate assist audits, and to ensure adequate audit coverage of joint venture costs.

### **37-3 Accounting Considerations**

A joint venture, proposed and established as a separate business entity, should have its own set of books and supporting documentation sufficient for an audit trail. Transactions should be recorded consistent with the joint venture agreement, and care must be taken to ensure that the joint venture bears its equitable share of the costs.

#### **Incorporated Joint Ventures**

Under GAAP, investors will usually account for incorporated joint ventures using one of three methods: the equity method, the cost method, or the fair value method. The equity method is appropriate when an investment enables the investor to exercise significant influence over operating or financial decisions of the investee. ASC 323, Investments – Equity Method and Joint Ventures describes the use of the equity

method. ASC 323-10-05-4 notes that the equity method best enables investors in corporate joint ventures to reflect the underlying nature of their investment in those ventures. If the investor does not exercise significant influence, the cost method or fair value method apply depending on the specific circumstances. ASC 325-20, Investments – Other, Cost Method Investments describes the cost method. ASC 320, Investments – Debt and Equity Securities addresses the fair value method.

### **Unincorporated Joint Ventures**

The provisions of ASC 323 have generally been interpreted as being applicable to unincorporated joint ventures as well as incorporated joint ventures (refer to ASC 323-30 for details). Therefore, in most circumstances when the investment in an unincorporated joint venture permits significant influence by the investor over the investee, the equity method is appropriate.

### **Joint Venture Accounting as a Partnership**

If a joint venture elects to be treated as a partnership, or is required by either the Federal tax code or any state's partnership laws to be treated as a partnership, then the joint venture should:

- adopt accounting practices that are consistent with the single entity concept, and
- maintain a complete set of books and records.

### **Teaming Arrangements**

The accounting for teaming arrangements should be consistent with the form of business organization that the teaming contractors have agreed to and disclosed in their proposal(s). For example, if the agreed-to arrangement is in the form of a joint venture, then this should be disclosed in the proposal(s) and the accounting principles applicable to a joint venture should be followed. FAR 9.603 requires contractors to fully disclose all teaming arrangements in their offers. If an arrangement is entered into after submitting an offer, then disclosure is required before the arrangement becomes effective.

When the characteristics of joint control (i.e., joint property, joint liability for losses and expenses, and joint participation in profits) are evident, then the business arrangement is a joint venture. If the characteristics of joint control are not evident, then the terms of the business arrangement should be reviewed to see if a prime contractor/subcontractor relationship exists between the parties. It should be noted that a disclaimer of a joint venture arrangement in itself does not preclude an arrangement from being classified as a joint venture if it possesses the characteristics of a joint venture.

## **37-4 FAR and CAS Considerations**

### **37-4.1 Consideration of FAR**

The FAR does not specifically address a joint venture as a party in the procurement of supplies and services under Government contracts. It is therefore necessary to understand the purpose for and characteristics of a joint venture when reviewing the venture in terms of the FAR, specifically the FAR cost principles on allowable costs.

### **37-4.2 Cost Allocation**

There is no one cost allocation model which covers contracts issued to all joint ventures and teaming arrangements. The range includes everything from models where all costs are incurred at the contracting entity to models where no costs are incurred at the contracting entity. The former model is a normal prime contracting scenario and the latter is descriptive of joint venture that has no employees or assets of its own.

Many contractors either have their joint ventures "borrow" employees from other segments of the contractor or have the other segments perform the tasks normally performed by the prime contractor in place of the joint venture. In either case, the arrangement may create a home office at the segment providing the services to the joint venture. A home office provides management services or supervision to two or more segments. For CAS-covered contractors, the home office costs must be disclosed and be compliant with CAS 410.50(h) and CAS 403. The tasks performed by the home office for the joint venture may include a wide range of functions; e.g., general management, bid and proposal, independent research and development, selling, contract administration, material handling, procurement, computer services, personnel services, etc. When a segment begins to perform indirect functions for another segment it may present new labor charging and timekeeping problems requiring new training and internal controls.

In extreme cases, joint ventures have no employees or assets. All the deliverable services and products are designed, manufactured, assembled, and provided by other operating segments of the contractor. These operating segments only transfer the costs to the joint venture for billing purposes. All G&A/B&P/IR&D, any specifically identifiable contract management functions, and any other indirect costs are performed by one or more of the contractor's other segments, making those segments home offices which must allocate the costs to the joint venture.

### **37-4.3 Allocation of Home Office Expenses to Joint Ventures and Teaming Arrangements**

Additional consideration is necessary when a joint venture or teaming arrangement is established as a [CAS 403](#) segment with the venturing companies acting as intermediate home offices for their share of the venture costs. Such arrangements

usually involve the adoption of a “special” method of allocating residual home office expenses wherein each venturer allocates a portion of its residual expenses to their portion of the joint venture costs. For a contractor not subject to CAS, although not required to comply with CAS 403, the CAS may be used as a model in determining contractor compliance with FAR 31.201-4 and FAR 31.203.

If the joint venture or teaming arrangement is considered a segment in accordance with the definition of CAS 403, the auditor needs to ensure that each of the venturing companies:

- identifies and directly allocates those home office expenses that were specifically incurred in support of the joint venture,
- separately allocates to the joint venture its share of home office support expenses from any homogeneous pools, and
- adopts one of the following practices for the allocation of residual expenses:
  - (i) The venturers can request a special allocation of the residual expenses in accordance with the criteria in CAS 403.50(d)(1).
  - (ii) The majority or controlling contractor can treat the joint venture as a segment of its company, and include the entire operations of the venture in its formula for allocating residual expenses.
  - (iii) The minority contractor may also allocate its company's residual expenses to joint venture, but is not required to.

The joint ventures and teaming arrangements that have not been formed as separate CAS 403 segments generally do not have, and would not be expected to have, significant assets or payrolls (elements of the three factor formula for allocating residual expenses). Home office expenses are allocated to the contracts of these joint ventures in the same manner that the venturing companies allocate these expenses to their other contract work.

When residual home office expenses are allocated using the three factor formula, CAS 403 requires that inter-segment sales be claimed at the segment which produced the contract deliverable product or service. When determining the sales factor to be used in the three factor allocation for residual expenses at a home office or a group home office, CAS 403.50(c)(1)(ii) requires that each segment in the allocation grouping include inter-segment sales in its sales total and then reduce its sales total by the amount of purchases from other segments in the allocation grouping.

CAS 410.50(d) 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. Only in instances where a particular final cost objective in relation to other final cost objectives receives significantly more or less benefit from G&A expense can the contractor deviate from this requirement. All special allocations of this nature must be handled in accordance with CAS 410.50(j). Such special allocations may be

appropriate in unusual circumstances that are not expected to recur. To the extent that subcontracts or any other significant element of cost input, representative of the total activity of the unit, are excluded from the base, a noncompliance occurs.

CAS 420.50(f)(2) requires that the cost input base used to allocate IR&D/B&P costs to all final cost objectives be the same as the G&A allocation base. As with G&A above:

- only in instances where a particular final cost objective in relation to other final cost objectives receives significantly more or less benefit from IR&D/B&P costs can the contractor deviate from this requirement; and
- to the extent that a significant element of cost input is excluded from the base, a noncompliance occurs.

CAS 418.50(d)(2) states that a material cost base is appropriate if the activity being managed or supervised is a material-related activity. Upon selection of a material cost base, all significant elements shall be included in that allocation base.

When reviewing joint ventures or teaming arrangements that have been established as a separate business entity and which have a CAS-covered contract the auditor should:

- (1) Treat the venture as a separate contractor segment, even if the venture has few, if any, assets or employees, and no up-front investment.
- (2) Ensure that all of the costs that should be allocated to the venture are appropriately allocated to the venture in accordance with the provisions of CAS. (G&A and IR&D/B&P, for example, should be allocated to the venture according to the provisions of CAS 403, 410, and 420.)

When reviewing joint ventures and teaming arrangements that have not been established as a separate business entity, the auditor should:

- (1) Determine the reasons why the venture is not being treated as a separate entity or CAS business unit/segment. For example, does the venturer claim that a separate segment does not exist because:
  - the venture has no assets, employees, or up-front investment, and/or
  - the cost impact of establishing the venture as a separate entity is not significant enough considering the extra administrative costs involved?
- (2) Determine how the venture and venturing companies are being treated and accounted for. For example, are the venturing companies being treated as independent contractors (vs. subcontractors to the joint venture)?
- (3) Develop a position based on appropriate consideration of:
  - the CAS requirements,
  - the principle of “substance over form,”

- materiality of the cost impact associated with establishing a separate entity, and
  - the [intent of the contracting officer](#).
- (4) Meet with the contracting officer and/or administrative contracting officer to:
- discuss your findings and the contracting officer's position with respect to the arrangement, and
  - work toward changing any unsuitably proposed or established joint ventures.
- (5) Communicate any adverse impact associated with the joint venture arrangement (i.e., CAS noncompliance or accounting inconsistency) to the ACO, cognizant PCO, and other PCOs affected by the arrangement, and continue to closely monitor the arrangement for such an impact.

#### **37-4.4 Changes in Cost Accounting Practices**

Once a CAS-covered joint venture is established, and there are no apparent CAS noncompliances associated with the allocation of costs, the auditor must next determine whether the joint venture has impacted the costs on any existing company contracts, and if so, whether a change in cost accounting practice occurred. Each organizational change must be evaluated separately to determine whether a change in cost accounting practice has occurred. Specific criteria for making these determinations are provided in [48 CFR 9903.302](#) and CAM Section 8-303.3.

When reviewing a joint venture to determine the cost impact on existing company(s) contracts, care must be taken to distinguish between:

- (1) the cost impact due to the change in the measurement, allocation, and assignment of costs and
- (2) the impact due to the initial adoption of a cost accounting practice, or the partial or total elimination of a cost or the cost of a function, which are not considered changes in cost accounting practices under CASB rules and regulations.

#### **37-4.5 CAS Disclosure Statements**

Any contractor which, together with its segments, receives net awards of CAS-covered negotiated Government contracts totaling \$50 million or more in its most recent cost accounting period must submit a CAS Disclosure Statement (48 CFR 9903.202-1(b)). Any business unit that is selected to receive a CAS-covered negotiated Government contract or subcontract of \$50 million or more is also required to submit a Disclosure Statement.

Joint ventures are composed of two or more contractors each of which may have already filed a Disclosure Statement because of having obtained other Government

contracts. Review the characteristics of the joint venture to determine if the joint venture meets the definition of a CAS segment.

The need for a joint venture CAS Disclosure Statement depends upon the characteristics of the venture itself. The determination must be made on a case-by-case basis. Where the joint venture is the entity actually performing the contract, has the responsibility for profit and/or producing a product or service, and has certain characteristics of ownership or control, a Disclosure Statement should be required. Where the venture merely unites the efforts of two contractors performing separate and distinct portions of the contract with little or no technical interface, a separate joint venture disclosure may not be required. Where doubt exists, discuss the circumstances with the contracting officer.

### **Frequently Asked Questions**

**Question 1:** What is a Special Business Unit?

**Answer:** A Special Business Unit (SBU) is the term used within our Agency to describe business organizations established by a single contractor to:

- support a single contract, program, or product line;
- limit financial, tax, or legal liability; and/or
- gain a technical or cost advantage.

An SBU may be a wholly-owned subsidiary, a corporate division, or a joint venture/partnership composed of segments of the contractor.

### **Callout**

**Joint Control** – For example, joint property, joint liability for losses and expenses, and joint participation in profits. ([Return](#))

**Business segment** - Note that the CAS and ASC definitions for "segment" are not the same. The CAS/FAR definition is the relevant definition for Government cost accounting purposes. ([Return](#))

**Entities that do not satisfy the basic criteria for a segment or business unit are actually an undivided part of a contractor business unit** - Therefore, separate allocations to such would often be in noncompliance with those provisions of CAS (e.g., 402, 403, 410, 418, and 420) which deal with the consistency and fragmentation of allocation bases. ([Return](#))

**Business Organization** - The joint venture and teaming arrangement guidance in this section has been written to specifically cover unincorporated joint ventures, and may not apply to incorporated joint ventures. ([Return](#))

**CAS 403 segment** – For a contractor not subject to CAS, although not required to comply with CAS 403, the CAS may be used as a model in determining contractor compliance with FAR 31.201-4 and FAR 31.203. ([Return](#))

**Intent of the contracting officer** - If a preliminary position is developed which substantially differs from, or conflicts with, the intent of the contracting officer, elevate this matter through normal channels to the attention of the HQ PAC Division. ([Return](#))

**48 CFR 9903.302** - The CAS Board stated that while organizational changes by themselves are not changes in cost accounting practices, such changes may cause a change in a contractor's cost accounting practices. ([Return](#))

### **Definition**

**Segment** - FAR 2.101: "Segment" means one of two or more divisions, product departments, plants, or other subdivisions of an organization reporting directly to a home office, usually identified with responsibility for profit and/or producing a product or service. The term includes—(1) Government-owned contractor-operated (GOCO) facilities; and (2) Joint ventures and subsidiaries (domestic and foreign) in which the organization has—(i) A majority ownership; or (ii) Less than a majority ownership, but over which it exercises control. ([Return](#))

**Business unit** - FAR 2.101: "Business unit" means any segment of an organization, or an entire business organization that is not divided into segments. ([Return](#))