

DCAA

PreAward Accounting System Surveys

Establishing and maintaining an adequate accounting system is not only important but also required in the contract regulations

Many government contractors understand, based on their experience and knowledge of the regulations, the importance of establishing and maintaining an adequate accounting system. But some are not aware of the regulatory requirements for doing so, and others fail to understand just what constitutes an adequate accounting system. This article explores the regulatory requirements for establishing and maintaining an adequate accounting system, as well as some of the attributes these accounting systems should have. It focuses on the preaward accounting system survey applicable to both major and nonmajor contractors as defined by the Defense Contract Audit Agency (DCAA).

If a company is submitting a proposal for a cost-reimbursement defense contract, it is likely that DCAA will be asked by a contracting officer to audit the company's accounting system and to complete a Standard Form (SF) 1408, Preaward Survey of Prospective Contractor Accounting System. Note that the word "contractor" used in this article means prospective contractors.

The Federal Acquisition Regulation (FAR) 16.301-3 (Limitations), states that "A cost-reimbursement contract may be used only when ... the contractor's accounting system is adequate for determining costs applicable to the contract." FAR Subpart 32.5 (Progress Payments Based on Costs), and more specifically FAR 32.503 (Postaward Matters), contains several provisions related to maintaining an adequate accounting systems and controls.

These state that a preaward review of accounting systems and controls is permissible before the award of a contract that provides progress payments based on costs. FAR 9.104-1, General Standards, states that "To be determined responsible, a prospective contractor must ... (e) Have the necessary ... accounting and operational controls ...". FAR 9.105-1, Obtaining Information, requires the administrative contracting officer or the procuring contracting officer to obtain from the auditor any information required concerning the adequacy of prospective contractors' accounting systems and these systems' suitability for use in administering the proposed type of contract.

The audit program requirements for preaward accounting system audits can be found at www.dcaa.mil. Once in this site, click on "Audit Guidance," then "Standard Audit Programs." The audit programs for preaward accounting system audits and postaward accounting system audits of nonmajor contractors are found under Activity Code 17740. The primary purpose of the preaward audit is to obtain an understanding of the accounting system to appropriately complete the SF 1408. The accounting system requirements audited under these steps follow. Note that individual auditors may differ in their styles and methods for completing the audit steps; this article is intended for general guidance only.

Accounting System Requirements

The contractor's accounting system must be in accordance with Generally Accepted Accounting Principles (GAAP). Through various tests, the auditor will determine whether the contractor has, or intends to have, an accrual basis accounting system. It is usually helpful if the contractor has financial statements compiled, reviewed, or audited by an outside certified public accounting firm. Still, some inquiries and tests will be performed to determine whether the overall system is maintained in accordance with GAAP.

Controls

The contractor must have controls to preclude the direct charging of indirect expenses and vice versa. A flowchart, or similar document, is helpful in demonstrating the flow of expense transactions from a purchase requisition, to a purchase order, to a receiving document, if applicable, and then to the invoice from the vendor. For service-related expenses, a formal contract, subcontract, or engagement letter is helpful in determining whether an expense is direct or indirect. In any case, the charge number (direct or indirect) should be shown on the documents at the earliest possible stage. A system of review and approvals is essential in meeting this requirement. It is important for

the contractor to prepare and maintain written policies and procedures for the identification of direct and indirect costs and that these policies be disseminated to employees preparing and reviewing relevant documents. For contractors covered by the Cost Accounting Standards, these policies and procedures are required under Cost Accounting Standard No. 418.

Job-Cost Ledger

The contractor must have either a subsidiary job-cost ledger or accounts receivable ledger that accumulates costs by contract at a level consistent with that used by the prospective contractor in its proposal. The SF 1408 requirement is that the accounting system provide for the identification and accumulation of direct costs by contract.

Pools

The contractor must accumulate indirect costs in logical cost groupings (also called pools), and the costs must be allocated based on benefits accrued to other intermediate cost pools or to contracts. A prospective contractor should have a chart of accounts that shows how indirect costs are grouped in pools and will be asked to produce a current general ledger trial balance that matches the chart of accounts.

Auditors will determine whether the indirect costs are grouped in logical pools and allocated based on a causal or beneficial relationship with the base costs. For example, a facilities cost pool would not include the costs of the accounting or personnel departments. Equally important is the requirement that a prospective contractor formally document its cost accounting system with a written description of the contents of pools and bases. This documentation requirement better enables the auditor to understand the construction of the pools and bases and helps the prospective contractor to meet the consistency requirement on the SF 1408.

General Ledger

The requirements for pools lead to the next requirement, that is, that the prospective contractor must accumulate costs under general ledger control. This is a simple test that should be performed by any contractor before DCAA begins the audit. Very simply, the contractor's job-cost ledger must reconcile with the general ledger. For example, on-site labor posted to each contract in the job-cost ledger must equal the same on-site labor account posted to the general ledger.

Timekeeping System

The SF 1408 requires "A timekeeping system that identifies employees' labor to the appropriate cost objectives." A cost objective is usually a contract, an independent research and development project, a bid and proposal project, an intermediate cost pool, or an indirect pool, such as overhead and general and administrative expenses. This requirement is very simple, yet so problematic for contractors. It requires that employees prepare timesheets or timecards, either manually or electronically, and that the timekeeping document be signed by the employee and the employee's supervisor.

Labor Distribution System

The SF 1408 mandates a labor distribution system for the proper allocation of direct and indirect labor to cost objectives. The labor distribution reports summarize labor charges by employee and cost objective. Contractors should determine that the labor distribution reports reconcile to the payroll register for every period. Contractors also must ascertain that the labor distribution reports reconcile to the corresponding general ledger accounts.

Monthly Posting

The auditor is instructed to determine that the contractor posts contract costs at least monthly to the books of account. This includes direct contract costs and indirect costs. It also includes all books of account (e.g., the general ledger, job-cost ledger, labor distribution reports, and other subsidiary ledgers). These costs must be posted in accordance with GAAP so that the year-end

posting of certain costs, such as depreciation, defined benefit pension costs, and the like, will be estimated and posted monthly and then adjusted to actual costs at year end. It also requires the accrual of accounts, such as accounts payable, employee leave accounts, and others.

Exclusion of Unallowable Costs

Every contractor must exclude unallowable costs, as defined in FAR Part 31, and contract provisions from other costs charged to government contracts. Contractors must have a system for identifying and excluding unallowable costs. Most contractors set up unallowable cost accounts in their general ledgers and identify each cost separately at the document-processing and review-and-approval stages to determine cost allowability or unallowability. Employees in the accounting department must become knowledgeable about the requirements of FAR Part 31 to segregate unallowable costs at the point of entry into the accounting records. Auditors will determine whether the contractor has a plan to identify and exclude unallowable costs if the contract is awarded.

Segregation of Costs

If required by the contract, the contractor's accounting system must provide for the identification of costs by contract line item and by units, as if each unit or line item were a separate contract. Contractors who segregate costs in their accounting systems by delivery order probably have this capability. Manufacturing contractors must have a system that segregates preproduction costs to assist in repricing or follow-on contract pricing. This is important so that preproduction costs are not paid twice for a particular product line.

Funding Limitation

Interim indirect expense rates must be calculated monthly from the books of account and must be routinely monitored. The auditors will want to know who is responsible for monitoring total contract expenditures against contract limitations to comply with FAR 52.232-20 and 21, and FAR 52.216-16. How often are they reviewed? Are controls in place to ensure compliance with the reporting requirements of these FAR provisions? It is helpful for contractors to prepare abstracts of contracts, so they can routinely monitor contract cost and funding limitations. Someone should compare costs accumulated to date on a contract to the cost or funding limitation to ascertain that the appropriate notification requirements are met.

Interim Billing

Contractors must prepare interim billings of direct costs directly from the books and records, excluding unallowable costs. Costs of items or services purchased directly for the contracts may be claimed for reimbursement only if the costs will be paid in accordance with the terms and conditions of the subcontract or invoice and ordinarily will be paid before submission of the contractor's next payment request to the government.

The auditor will take a sample of bills submitted and trace them to the job-cost ledgers and to provisional billing rate letters for indirect costs to test compliance with this requirement. This will be done for both current and cumulative costs claimed. Therefore, the records must show current and cumulative amounts must be accrued

Pricing Follow-On Work

The accounting system must be designed and records maintained in such a manner that adequate, reliable data are developed for use in pricing follow-on acquisitions. For manufacturing companies, costs should be segregated by lots, and engineering costs must be segregated from manufacturing costs — this is so a learning curve can be applied in pricing follow-on work.

Full Operational Capacity

Finally, the auditor must ascertain that the accounting system is currently in full operation. Some prospective contractors do not present fully operational accounting systems because they have only firm-fixed priced contracts or currently do only commercial work. If the system is not currently

generating inputs and outputs, the auditor must report on the SF 1408 that the system, although it is set up, is not yet in operation. In these cases, the auditor may recommend on the SF 1408 that the system is acceptable for award of a prospective contract but additionally recommend that a follow-on accounting system review be performed after contract award.

It is advisable for contractors to create adequate systems using data from their fixed-price or commercial work just to demonstrate that the system does everything that it is supposed to do. It does not take much work, and it is time well spent.