

VI. INTERIM GUIDANCE CAS WORKING GROUP

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February 24, 1976

WG 76-1

SUBJECT: Interim Guidance for implementing CAS 412

Background

Cost Accounting Standard 412--Composition and Measurement of Pension Cost was promulgated on 24 September 1975 (Federal Register, Vol. 40, No. 186). The effective date of the Standard was 1 January 1976.

Beginning with the Standard's effective date, all effort on new contracts that is projected to occur after this Standard becomes applicable, must be estimated in conformance with its provisions. (Though the requirement for pricing begins with the effective date, actual compliance in regard to contract costing is required after the beginning of the next cost accounting period following the receipt of a contract to which this Standard applied.) For example, Contractor A, whose accounting period begins 1 July 1976, is awarded a CAS-covered contract on 1 May 1976. The proposal for the contract was submitted 15 January 1976. According to the provisions of CAS 412, Contractor A will be required to comply at the beginning of its next fiscal year (1 July 1976). Since the proposal was submitted after the effective date, the effort projected to occur after the applicability date (1 July 1976) must be estimated in conformance with CAS 412.

Discussion

Under Section 412.50(b)(2) of the Standard, a contractor using an aggregate cost method to measure pension cost is required to make an alternative calculation to ascertain the funding status of the pension plan. The intent of this provision is to reduce the pension cost determined by the aggregate method for any excess funding disclosed by the alternative calculation. Where appropriate, this adjustment should be reflected in estimating the cost of contract effort scheduled to be performed after the Standard becomes applicable.

It appears likely that a substantial number of affected contractors will be unable to make the required alternate computation prior to the period when the standard will be applicable. Thus, proposals submitted may not reflect proper pension costs. This condition could cause the issuance of an inordinate number of noncompliance reports and, to a large extent, impede the negotiation process. Where such conditions occur, this guidance outlines a course of action for contracting officers to follow which will minimize the need for issuing noncompliance reports and facilitate the pricing and the negotiation of contracts while adequately protecting the Government's interest.

Guidance

When companies using an aggregate actuarial cost method demonstrate, to the satisfaction of the ACO, the inability to make the alternate computation (CAS 412.50(b)(2)) as required by the standard, the following guidance should be followed.

1. The ACO shall establish a specific date for the contractor to furnish the alternate computation required by Standard (412.50(b)(2)).
2. Contract negotiations should be conducted using the actuarial cost method currently employed by the contractor.
3. Contract terms should include a provision for a price adjustment for any significant cost impact resulting from the alternate computation required by the Standard. If a substantial overpayment results, interest should be assessed at a rate prescribed by the provisions of Public Law 91-379.

February 24, 1976

WG 76-2

Interim Guidance for Administration of Cost Accounting Standards (CAS)

SUBJECT: Application of CAS to Contract Modifications and to Orders Placed Under Basic Agreements

Background

Questions arise from time to time on how and when CAS is to be applied to changes negotiated on existing contracts. There have also been questions on when CAS should be applicable to Basic agreements and to the orders placed pursuant to such agreements (ASPR 3-410.1 and 3-410.2). In the case of contract modifications the question often comes up when an advertised contract is modified requiring negotiation of a price adjustment which involves costs above the \$100,000 or \$500,000 CAS threshold. Similar questions arise when a negotiated contract not subject to CAS is modified and the pricing action involves amounts that exceed the threshold for CAS application.

In the case of Basic agreements under which orders are placed from time to time, as is the case with Basic ordering agreements, the question is whether CAS should be applied only to orders which exceed the CAS threshold or whether the sum of all orders should be considered. If the latter policy is followed, CAS would apply to all orders regardless of individual dollar amount if their sum exceeded the threshold for CAS.

Guidance

With respect to contract modifications the general rule is that any modifications made to a contract pursuant to the terms and conditions of the contract will not affect the status of the contract with respect to CAS application. That is, if CAS was applicable to the original contract, it will be applicable to the modification, if CAS was not applicable to the original contract, it will not apply to the modification.

Notwithstanding the apparent simplicity of this concept, there are many cases when it may be difficult to decide if CAS is applicable. The following examples are furnished to provide guidance for types of cases that have come to the attention of the CAS Working Group and Steering Committee.

1. The contract was advertised and not subject to CAS, but it contains an option for additional quantities that would exceed the threshold for applying CAS.

- a. At a fixed price
- b. At a price not to exceed 125% of initial quantity

In the case of "a", there should be no doubt that the option quantity would not be subject to CAS, because it was part of the original advertised solicitation and award was made in accordance with the rules of advertising. In the case of (b), there may be a question since an element of negotiation appears to be involved in establishing the final price. Nevertheless, a firm ceiling price was established and was considered at the time of the initial contract award. CAS would not apply.

If at the time the option is exercised, a decision is made to increase the quantity beyond the amount provided for in the option clause, and if the price negotiated for this portion of the increase exceeds the CAS threshold, CAS will apply to that portion. This increment was not contemplated under the terms of the original contract and must therefore be treated as if it were a new negotiated contract.

2. The contract was negotiated and called for a quantity that was priced below the threshold for CAS (\$100,000 or \$500,00 as the case may be). The contract includes an option that, added to the initial requirement, would exceed the CAS threshold.

This contract was subject to CAS at the outset because it contemplates a total requirement in excess of the CAS threshold.

In the case of Basic Agreements, 3-410 specifically states that they are not contracts (3-410.1(a)). The same statement appears in 3-410.2(a)(1) with definitions of these two agreements are only to be used to establish certain terms and conditions under which contracts may be placed.

The individual contracts or orders are therefore to be individually considered when determining the applicability of CAS. If the CAS dollar threshold is reached and the negotiated contract or order is not otherwise exempt under the CAS rules and Regulations the contract or order is subject to CAS.

WG 76-3

SUBJECT: Interim Policy for Application of Cost Accounting Standards
(CAS) to Subcontracts

References:

- a. Cost Accounting Standards (CAS) Clause
- b. DAR 7-104.83(a), paragraph (a)(3) and (d)

Background

Paragraph (a)(3) of the CAS Clause requires the contractor to "comply with all cost accounting standards in effect on the date of award of this contract..." Prime contractors and subcontractors are required by paragraph (d) of the clause to flow its provisions down to lower tier subcontractors.

It is clear that paragraph (a)(3) requires prime contractors to comply with all standards that are effective when the contract is placed. This requirement has also been applied to subcontracts. Recently, however, we have learned that the CAS Board does not construe its rules to require subcontracts to be subject to any standards which are not effective for the prime contract at the time the prime contract is awarded, except to the extent necessary to comply with the second sentence of paragraph (a)(3) of DAR 7-104.83. ("The contractor shall also comply with any cost accounting standard which hereafter becomes applicable to a contract or subcontract of the contractor.")

Discussion

After careful consideration of the CAS Board interpretation and its impact, we have concluded that, in many cases, the administrative effort to implement this approach could be considerably greater than that required when subcontracts are subject to all standards in effect at the time the subcontracts are placed. This is evident when the two situations are compared. In the one instance, each new subcontract would bring with it all current standards. This would leave no doubt as to the standards applicable to all the contractor's CAS covered work. In the other case, it would be necessary to track back to the prime contract to determine the standards that were effective. Following this, other existing contracts and new awards would have to be reviewed. The results of this would disclose which prime or subcontract included the latest standards, and thus establish the standards applicable to all CAS work.

Admittedly, the problem of identifying standards could be alleviated by requiring the prime contractor and each subcontractor to identify the standards applicable when they place a subcontract. However, this procedure, at best, would still require greater administrative effort than a criterion based on the time of subcontract award.

Guidance

In view of the above, contracting officers should be advised to require their prime contractors to include language in their CAS flow down clause which requires the subcontractors at all tiers to comply with all standards, rules and regulations in effect at the time the subcontract is awarded. In unusual cases, the Head of the Procuring Agency should waive the requirement if, in his judgment, such a waiver is necessary; provided, however, that such waivers cannot relieve the subcontractor from compliance with rules and regulations established by the CAS Board. Thus, the flow down clause must require as a minimum that standards applicable to the prime contract at the time it was awarded shall be applicable to the subcontract and further, that standards applicable to any of the subcontractor's other prime or subcontracts shall also be applicable to the subcontract.

1 October 1976

WG 76-4

SUBJECT: Determining Increased Costs to the Government for CAS
Covered FFP Contracts - Interim Guidance

Background

Paragraph 4 CFR 331.70(b) of the CAS Rules and Regulations discusses the concept of "increased costs" on firm fixed-price (FFP) contracts as related to noncompliances, i.e., failure to follow disclosed practices or cost accounting standards.

DOD guidance on "Increased Costs Paid Under CAS-Covered Contracts" contained in DPC 75-6 gave an example of increased costs on FFP contracts where there was a noncompliance that resulted in less costs being allocated to the FFP contract than would have been had the appropriate practices been followed.

Discussion

In cases other than noncompliance the opinion has been expressed that no increased cost can occur unless the contract price of a FFP contract is actually increased. This concept cannot adequately protect the Government as was contemplated by PL 91-379, because it provides a situation under which a contractor may overtly or inadvertently adjust accounting procedures so as to cause less costs to be allocated to FFP contracts. The contractor may thus receive a windfall.

To protect the Government in all situations where FFP contracts are involved it is therefore necessary to recognize the phenomenon that occurs when cost allocations are decreased due to accounting changes. The CAS Board did so in 4 CFR 331.70(b). A basic premise of this paragraph is that the amount of such decrease represents the amount of "increased costs to the Government." It is logical that this premise be extended to apply to all cases involving FFP contracts.

Guidance

Increased costs to the Government under firm fixed price contracts should be considered to exist when the costs allocated to the contracts are less than would have been allocated if the method of allocation had not been changed.

1 October 1976

WG 76-5

SUBJECT: Interim Guidance on Treatment of Implementation Costs
Related to Changes in Cost Accounting Practices

Background

When a cost accounting practice is changed, whether the change is mandatory (issuance of a new cost accounting standard) or voluntary (any change other than mandatory) costs to implement the change may be incurred. Questions have arisen as to whether implementation costs associated with such practice changes may be included in cost impact statements, and whether such costs should be charged only to CAS covered contracts.

Discussion

Since mandatory changes are required because of CAS Board actions, it has been proposed that total implementation costs should be allocated only to CAS covered contracts. In the case of voluntary changes, CAS Board regulations state that there can be no increased cost to the Government. This adds additional significance to the question of whether implementation costs should be included in the cost impact statement. Cost of implementing changes to accounting practices may include the cost of work performed by the contractor's personnel and/or work performed by outside organizations. Such costs are normally included in the contractors' overhead accounts and allocated to appropriate cost objectives.

Guidance

Implementation costs may be included in cost impact statements only to the extent they are a part of appropriate indirect expense pools, and allocated in accordance with the contractor's normal accounting practices. This principle applies to both voluntary changes and changes resulting from the issuance of Standards.

1 October 1976

WG 76-6

SUBJECT: Interim Guidance on Application of CAS Clause to Changes in Contractor's Established Practices when a Disclosure Statement has been Submitted

Background

Contractors and subcontractors are required to disclose in writing (Disclosure Statement) their cost accounting practices under the criteria set forth in 4 CFR 351.40 and 351.41 of the CAS Rules and Regulations. For those contractors and subcontractors who are not required to submit a disclosure statement their "established cost accounting practices" govern.

ASPR 3-1205 requires the ACO to make a determination as to whether the disclosure statement adequately describes the contractor's cost accounting practices. In order to be deemed adequate, the Disclosure Statement submitted by the contractor must be current, accurate, and complete.

Discussion

A contractor required to submit a Disclosure Statement may have a cost accounting practice which may not be specifically covered by Disclosure Statement Form CASB-DS-1 or there may be other reasons why the practice was not disclosed; therefore, the practice will not be considered a "disclosed practice." When this nondisclosed cost accounting practice is revised due to either a mandatory or voluntary change, the question arises as whether there is a requirement for a revision to the Disclosure Statement and a contract price adjustment. The CAS clause discusses changes to an "established cost accounting practice" as well as a "disclosed cost accounting practice." When a contractor is required to disclose his practices, he is, in effect, disclosing his established practices and should be disclosing all relevant cost accounting practices. Therefore, a cost accounting practice not disclosed is considered an "established cost accounting practice" whether or not it should have been disclosed on CASB-DS-1.

Guidance

When an ACO makes a determination that the contractor's Disclosure Statement is adequate, it does not necessarily indicate that the ACO is certifying that all cost accounting practices disclosed have been adequately described and the ACO currently is not aware of any additional practices that should have been disclosed. Subsequently, when it is discovered that a contractor is not following a cost accounting practice that he failed to disclose or a change to that practice is made, the practice will be considered an "established cost accounting practice" and appropriate guidance in ASPR 3-1200 on changes and noncompliances will be followed.

1 October 1976

WG 76-7

SUBJECT: Interim Guidance on the Significance of "Effective" and
"Applicability" Dates Included in Cost Accounting Standards
(CAS)

References:

- a. Cost Accounting Standards Clause
- b. DAR 3-1213

Background

Public Law 91-379 authorizes the Cost Accounting Standards Board (CASB) to promulgate cost accounting standards designed to increase uniformity and consistency in the accounting practices used by defense prime contractors and subcontractors. Companies are required to follow the standards in estimating, accumulating and reporting costs on Government procurements subject to the CASB rules and regulations.

To facilitate the implementation process, each promulgated standard carries its own statement (4 CFR4--.80) regarding the date it becomes effective and generally, a statement describing the time and conditions under which the standard should be applied to the contractor's accounting system--the applicability date.

The effective date designates the point in time the Government can require compliance with the standard's provisions. As a matter of policy, the CASB generally defers the application of the standard to the contractor's accounting system beyond the effective date. This deferral is intended to provide affected contractors adequate time to make necessary preparation for compliance and to provide a more convenient time to initiate the required accounting changes. In this regard, the CASB regulation provides that an effective standard need only be applied after the receipt of the first CAS-covered contract following the effective date. The applicability statement included in most standards extends the date the contractor must actually change his practices to the start of the next cost accounting period following the receipt of the triggering CAS-covered contract.

Since it is apparent that the effective date and the applicability date of a standard generally do not coincide, contracting personnel should be aware of the significance of these dates and understand the appropriate administrative actions required.

Discussion

Effective Date - Subparagraph (a)(3) of the Cost Accounting Standards Clause of DAR 7-104.83(a) requires compliance with all effective cost accounting standards as of the date of contract award or if the contractor has submitted cost or pricing data, on the date of final agreement on price as shown on the contractor's signed certificate of current cost or pricing data. Therefore, only those CAS-covered contracts in existence on the date a standard becomes effective will be equitably adjusted to reflect the prospective application of the new accounting requirements.

In summary, we can conclude that the effective date of a standard does two important things:

- a. Designates the point in time when the pricing of all future CAS-covered procurement must reflect the requirements of the newly promulgated standard, and
- b. Identifies those existing contracts eligible for an equitable adjustment to reflect the cost impact of applying, prospectively, the provisions of the new standard.

Applicability Date - This date marks the beginning of the period when the contractor must actually change the accounting and reporting systems to conform to the standard. Up to this point, only the estimates prepared after the standard's effective date had to take into account compliance with the new standard as more fully discussed below. From this point forward, covered contracts must be priced and the cost reported in compliance with all applicable standards.

As indicated earlier, the CASB sets the applicability date beyond the effective date in order to achieve a smooth implementation of the standard. However, special care is needed in considering contractors' proposals submitted for a contract to be awarded after a new standard's effective date but before the standard must be applied.

The proposed effort occurring after the effective date, but before the applicability date should be priced using the contractor's old accounting practice. Effort projected to occur on or after the applicability date should be priced in compliance with the new standard.

The equitable adjustment for those CAS-covered contracts in existence when a standard becomes effective should cover the period from the date the standards become applicable through contract completion.

Guidance

Procurement, administration, and audit personnel should carefully review the appropriate section of each newly promulgated standard to identify the effective date and the conditions governing the application of its provisions to actual practices.

A listing of all CAS-covered contracts and subcontracts in existence as of the standard's effective date should be obtained from the contractor. This listing, as confirmed with contract administration records, should represent those contracts eligible for equitable adjustments. DAR 3-1213 should be followed in administering any equitable adjustments caused by the new standard.

Proposals for contracts to be awarded after the effective date of a standard should be carefully reviewed to ascertain whether it reflects compliance with the standard. The proposal need only reflect compliance with the standard from the applicability date forward.

There will be instances where the impact of the standard cannot reasonably be predicted at the time the proposal is prepared or before the negotiations. Consequently, the effects of applying the standard cannot be reflected in the negotiated price. When this condition occurs, procurement officials should make use of contract provisions protecting the Government's interest.

17 December 1976

WG 76-8

SUBJECT: Interim Guidance on Use of the Offset Principle in Contract
Price Adjustments Resulting from Accounting Changes

Background

Paragraph (a)(4)(A) of the CAS clause provides for equitable adjustments when accounting system changes result from the issuance of new Cost Accounting Standards. Paragraph (a)(4)(B) of the CAS clause provides that the Contractor will negotiate, with the Contracting Officer, the terms and conditions under which a change to either a disclosed or established cost accounting practice may be made. These changes are generally referred to as "voluntary" changes. The (a)(4)(B) clause goes on to forbid any agreement that will result in increased costs being paid by the United States.

The interpretative language found in 4 CFR 331.70(f) advocates the offsetting approach with regard to voluntary changes whereby price adjustments are foregone to the extent that increases under one or more CAS-covered contracts are equaled or exceeded by decreases on other CAS-covered contracts. However, CAS publications including the CAS clause shed no light on how the offset technique may be related to mandatory changes, simultaneous accounting changes, multi-divisional accounting changes and changes affecting a diverse contractual mix.

Discussion

While the CAS Board explicitly advocates the use of the offset technique to preclude contract price changes under voluntary type, i.e., (a)(4)(B) changes, the technique can be equally useful in connection with mandatory changes, i.e., (a)(4)(A) type, if used for the same general purpose of netting out contract price changes and thus reducing the number of individual contract price adjustments required.

No specific method for applying the offset concept has been established. It remains the responsibility of the Administrative Contracting Officer to address each specific situation in a way that best accomplishes the overall objective. One method that may simplify the computation in many instances, as well as avoid the pitfalls described in item X of DPC 76-1, would be to compute the impact of a change by types of contracts (e.g., firm fixed price, cost type) and adjust as few contract prices as necessary within each group before merging the net impact from each contract group with that of other groups. Different approaches may provide a better procedure in other cases. For example, contracts may be grouped according to the relative materiality of the impact of the change (also see DPC 76-1). This type of segregation can be helpful in identifying contracts which can be eliminated from further consideration.

Another issue concerns the extent to which the offset principle can be used when several organizational segments of a company are affected by the same accounting change. As a general rule, whenever costs are flowing either from a higher organizational level or between segments, the offset universe may cover all affected segments. For example, a change that affects the flow of costs from a home office to several segments, could offset CAS-covered contracts within all affected segments. However, accounting changes that only affect the flow of costs within individual divisions should be treated as changes within each division.

The combining, for offset purposes, of several accounting changes within a segment as long as they have the same effective date should also serve to reduce the number of necessary contract price changes. Although individual treatment of voluntary changes could maximize the potential for downward price adjustments, the government's interests are adequately protected if no overall price increase is paid by the United States.

In summary, for those aspects of offset situations where specific CAS Rules and Regulations do not exist, Contracting Officers are still charged with exercising their best judgment on each individual impact study in a way that protects the best interest of the Government and considers the equity, fairness and materiality of the matter.

Guidance

1. Contracts may be adjusted individually or cost increases and decreases may be offset to reduce the number of contract adjustments for both (a)(4)(A) and (a)(4)(B) changes.
2. Cost increases at one organizational segment of a company may be offset by decreases at another segment if the change causes costs to flow between the segments either directly or via a higher organizational level such as a home office.
3. Within a segment, the effect of several changes may be combined in the offset consideration if the changes all take place at the same time.
4. When a mix of contract types is involved, grouping of contracts by type, by materiality of cost impact, or other type segregation may often reduce the complexity of the problem and also reduce the number of price adjustments that must be made.
5. The Contracting Officer is responsible for assuring that the offset technique is applied judiciously so that the final cost to the Government or to individual departments or agencies is not materially different from that which would have resulted if the contract prices had actually been adjusted.
6. Offsets affecting incentive contracts should be carefully reviewed to avoid material impacts on the incentive provisions.

17 December 1976

WG 76-9

SUBJECT: Interim Guidance for Measurement of Cost Impact on Firm
Fixed Price Contracts

Background

Paragraph (a)(4)(A) of the CAS clause provides for an equitable adjustment when accounting system changes result from the issuance of new cost accounting standards. Paragraph (a)(4)(B) of the CAS clause calls for negotiation of the terms and conditions under which a voluntary change to either a disclosed or established cost accounting practice will be made. Paragraphs (a)(5) of the CAS clause provides for recovery with interest of any over payments that have resulted from a contractor's failure to comply with either a Cost Accounting Standard or his disclosed practices. These paragraphs are silent as to the mechanics of the computation.

The interpretive language found in 4 CFR 331.70(b) describes the remedies to be applied where noncompliances occur in connection with (a)(5) type adjustments under firm fixed price contracts. 4 CFR 331.70(b) explicitly requires the use of original cost estimates from the time of negotiation of the contract adjusted to what they would have been had the contractor proposed on the basis of the practices actually used.

ASPM No. 1 (9A6 and 9A7) in addressing the general subject of the pricing of changes advocates the use of estimates to complete at the time of change is made rather than the original estimates.

Discussion

Although there is a certain theoretical purity to the use of original cost estimates for adjusting fixed price contracts for mandatory and voluntary changes, there are several serious impediments to that approach that are intrinsic to fixed price contracting. While the parties to a fixed contract have agreed to a total price, there is often no agreement as to how much of the price represents cost and how much profit and seldom a meeting of the minds on the amount of any individual element of cost. This will be particularly so if the award was based on adequate price competition. Further, many fixed price contracts will have undergone numerous price changes due to engineering modifications and other changes. In such cases, tracking of an individual cost element may prove virtually impossible. There is also the danger that the confusion resulting from the attempt to reconstruct the original data will provide an opportunity to reprice loss portions of contract performance that have elapsed prior to the point of the change.

The use of original cost estimates in cases involving noncompliances on Firm Fixed Price contracts may be more feasible where the noncompliant practice dates back to the beginning of the contract. However, there will still be occasions when tracking and cost identity problems will be almost insurmountable.

Guidance

Cost adjustments under either mandatory or voluntary changes should generally be the net difference between the current estimated cost to complete using the old accounting methods and the same estimate reconstructed to reflect the new methods.

Adjustments relating to noncompliance under firm fixed price contracts must comply with the CAS Board's requirement to use original cost estimates reflecting the noncompliant and compliant treatments. Should this prove impracticable, the problem should be forwarded through appropriate channels to the CAS Working Group.

2 February 1977

WG 77-10

SUBJECT: Retroactive Implementation of Cost Accounting Standards
When Timely Compliance is Not Feasible

Background

There are two significant dates in the implementation of cost accounting standards, the "effective" date and the "applicability" date. Working Group (W.G.) guidance paper #76-7 which provides discussion and guidance on these dates, states that the effective date "Designates the point in time when the pricing of all future CAS-covered procurement must reflect the requirements of the newly promulgated standard ..."; and the applicability date "... marks the beginning of the period when the contractor must actually change the accounting and reporting systems to conform to the standard." The applicability date of most standards is the beginning of the contractor's next accounting period after receipt of a CAS-covered contract following the effective date of the standard.

Discussion

There may be a few unusual situations when it is virtually impossible for a contractor to comply with a particular standard at its applicability date because the standard requires a major revision to a segment of the contractor's cost accounting system. In this instance, attempting to forecast the impact of the standard on a negotiated contract to be entered into after the effective date of the standard could be inequitable to either party. For example, CAS Standard 410 (Allocation of Business Unit G&A Expenses to Final Cost Objectives) was promulgated in final form on April 16, 1976, with an effective date of October 1, 1976, and an applicability date at the start of the next fiscal year beginning after January 1, 1977. Some contractors, for various reasons, have a fiscal year beginning on January 2 or 3, 1977. Therefore, the applicability date for those contractors were only about three months after the effective date (assuming that a CAS-covered contract was received in the interim period). There has been an indication that some of these contractors were unable to accomplish a major revision to their G&A expense pool and change to an appropriate cost input base in the time available. In the meantime, contract proposals received after October 1, 1976, have been required to be negotiated on a cost input basis and in these instances the accounting and reporting systems must be changed effective January 2 or 3, 1977, thereby creating a difficult condition.

Guidance

In unusual situations where a contractor can demonstrate to the satisfaction of the ACO, that it is virtually impossible for the contractor to comply with the effective or applicability dates of a standard the following guidance should be followed:

1. The ACD shall establish a specific date for the contractor to make the necessary changes to his estimating, accounting and reporting systems to be in compliance with the standard.

2. Negotiation of new firm fixed-price contracts after the effective date of the standard (but prior to the changes made in 1 above) should be conducted using the accounting practice employed by the contractor prior to the standard. The terms of these contracts should include a provision for price adjustment, retroactive to the applicability date, for any significant cost impact (increase or decrease) resulting from changing the accounting practice to comply with the standard.

3. After the effective date of the standard (but prior to the changes made in 1 above) negotiation of ceilings or target costs and fees or profit for new cost type or flexibly priced contracts should be conducted using the accounting practice employed by the contractor prior to the standard. The contract terms of these contracts should include a provision for a ceiling or target cost adjustment (and adjustment of fee or profit, if appropriate) for any significant estimated cost impact resulting from changing the accounting practice to comply with the standard. In addition, after the necessary changes to the accounting system are made in accordance with 1 ~~above~~, these changes must be made retroactive to the applicability date of the standard for costs allocated to these contracts.

4. When appropriate, changes in the contractor's Disclosure Statement to reflect the cost accounting practices required by the standard should also be accomplished by the date established in 1 above.

5. When the above procedures are followed, there will be no non-compliance reporting, and equitable adjustments computed as of the applicability date of the standard are in order.

2 February 1977

WG 77-11

SUBJECT: Interim Guidance for the Implementation of CAS 410,
Allocation of Business Unit General and Administrative
Expenses to Final Cost Objectives

Background

The standard provides criteria for allocating G&A to final cost objectives. It defines G&A expenses, provides guidelines for determining whether a particular expense should be included in the G&A expense pool and establishes cost input as the acceptable base for allocating G&A expenses. Contractors currently using sales or cost of sales (output) as a base are permitted to select one of two alternative procedures for changing to cost input. One method allows the immediate changeover to cost input on the date the standard's provisions must be applied; the other, allows a special transition which defers the complete changeover to cost input until all contracts received prior to the applicability date are completed. It is unmistakably clear, however, that the CAS Board's objective is to ultimately have all G&A, as defined in the standard, allocated to CAS-covered contracts on the basis of cost input.

Discussion

The CAS Board established an effective date of October 1, 1976 for CAS 410. To allow contractors sufficient time to prepare for compliance, the application of the standard was deferred. The earliest date a contractor can be compelled to change his accounting practices to comply is the beginning of his first fiscal year following January 1, 1977. Consequently, a contractor using the calendar year as his normal accounting period initially would be required to comply January 1, 1978. However, if the contractor's fiscal year begins on July 1, the earliest required for compliance would be July 1, 1977. Although not explicitly stated in the standard, it is important to know that a contractor must receive a CAS-covered contract on or after the standard's effective date before he has to apply the standard. In the examples, cited above, neither contractor would be required to apply the standard on the specified dates if no new CAS-covered contract had been received since the standard became effective.

The effective date of the standard also has special significance regarding the pricing of new procurements and for adjusting existing contract prices. In this regard, only those CAS-covered contracts existing on the effective date will be eligible for an equitable price adjustment. Except where the special transition method is used, contracts with award dates following the effective date of the standard and having performance periods extending beyond the date the standard must be applied, are to be estimated as follows:

1. Current G&A allocation base will be used to estimate, accumulate and report on contracts between the award and applicability dates.

2. Cost input base will be used to estimate, accumulate, and report on the remaining contract effort (applicability date through contract completion).

Under the special transition method for changing from a cost of sales or sales base to a cost input base, permitted by Appendix A of the standard, contractors will continue to use their current G&A allocation base to price contracts received up to the date CAS 410 must be followed. Contracts awarded on or after the applicability date will be priced using a cost input G&A base. This method effectively eliminates the need for an equitable price adjustment for this change since existing contracts priced on the basis of a sales or cost of sales G&A base will not be repriced to reflect the use of a cost input base. Instead, these contracts will remain on the sales or cost of sales base until completion.

Other changes required by the standard may require equitable adjustments whether the transition method is used or not: (1) when a contractor is required to change from one cost input base to another; e.g., total cost input to value added; and (2) where items do not satisfy the definition of G&A expense but have previously been classified as G&A must be reclassified in accordance with 410.40(d).

During the special extended transition period (begins when the standard is initially applied for accounting and reporting purposes and ends at the completion of the final contract priced on the basis of cost of sales or sales) two different bases are used to allocate a single pool of G&A expenses within an accounting period - cost of sales for the old contracts, cost input for contracts awarded on or after the date the standard is applicable.

The two bases used in a given accounting period during transition are not mutually exclusive but tend to overlap. That is, some of the same dollars may be included in both cost input and in cost of sales within the same accounting period. When this occurs, the possibility of allocating more G&A dollars to cost objectives than were expended during the accounting period is very real. The overallocation of G&A will more than likely occur because the G&A rates will be applied to an aggregate of contract work that exceeds the amount included in the individual bases used to determine the rates. In order to prevent windfalls and to provide equity to both parties, the standard requires the establishment of an inventory suspense account which shall, when certain conditions are met, be amortized in accounting periods subsequent to the transition period. The amortization of the inventory suspense account shall be used to reduce the G&A expense pool of the qualifying cost accounting periods. Notwithstanding the inventory suspense account provision, questions have been raised regarding the allowability under DAR XV, Part 2 of any overallocated expenses.

The standard also defines G&A as those expenses incurred for the general management and administration of a business unit as a whole. They must be allocated to final cost objectives on a base that measures the total activity of the business unit. Similar significant expenses whose beneficial relationship to cost objectives can be measured best on a base different from total activity, are to be excluded from the G&A expense pool. For the expenses remaining in the G&A expense pool, the standard prescribes the use of one of three cost input bases: (1) total cost input (2) value-added and (3) single elements. Conditions relating to the appropriate use of the three bases are described in the standard.

Under the standard, contractors may elect to include independent research and development (IR&D) costs, bidding and proposal (B&P) costs and selling costs in the G&A expense pool. The contractors also have the option to account for these expenses individually or in the aggregate in separate pool(s) and allocate them to cost objectives on a base(s) other than cost input. Where the latter alternative is selected, the standard requires that such expenses will be included in the G&A expense allocation base. If IR&D and B&P expenses are allocated on a base other than cost input, a question is raised as to whether the standard conflicts with ASPR 15-205.3 and 15-205.35 which provide that IR&D and B&P costs are not to be burdened with G&A. Attachment A clarifies this issue and demonstrates that no conflict exists.

The standard covers the treatment of items produced for stock after the applicability date but does not provide guidance for the treatment of items held in inventory on the first date the contractor must apply the standard. If such inventories are substantial or a disproportionate amount of these items are included in certain contracts, an inequitable allocation of G&A could result. It would appear that equity would require the inclusion of the inventory items in the G&A base in some future cost accounting period.

Guidance

Contractors whose existing practices require the allocation of G&A on either a sales or cost of sales basis may (i) use the optional transition method prescribed by Appendix A, CAS 410 or (ii) immediately change to a cost input base for all work to be performed after the applicability date and seek such equitable adjustment as may be appropriate under Paragraph (a)(4)(A) of the CAS contract clause.

Procurement officials must exercise special care in reviewing contractor's proposals submitted during the period when this election should be made (effective date through applicability date) to assure that contractors do not unwittingly select the transition method. For example, during this period a contractor submits a proposal with a performance period extending beyond the applicability date. If the entire contract is priced using the contractor's current practice of allocating G&A on the basis of sales or cost of sales, this contractor has effectively selected, perhaps inadvertently, the special transition method. Therefore, contracting officers should advise contractors regarding the significance of

the G&A allocation method used in preparing the estimate for the initial contract to which this standard applies. Requesting the contractor to submit a written confirmation of his election is an appropriate way to preclude any misunderstanding as to his intentions.

As noted in the discussion section, use of the two allocation bases during the transition will in all likelihood result in an overallocation of G&A. This condition will apply only to those contractors who elect the optional transition method rather than the equitable adjustment procedures. Any overallocated G&A resulting exclusively from the use of the transition method will not be questioned at this time. This interim position recognizes that the overallocated amount is inherent in the standard's requirements. This position also recognizes the CAS Board's contention that the establishment of an inventory suspense account actually prevents any overreimbursements. This aspect of the standard is under review and the above position may be revised.

CAS 410 requires inclusion of IR&D/B&P costs in the G&A input base when IR&D/B&P costs are accounted for in a separate pool and allocated on a base different from G&A. When distributing G&A expense to a contract, all properly allocable IR&D/B&P costs, including those in excess of negotiated ceilings, should be included in the cost base used to compute the G&A expense for that contract. Although IR&D/B&P costs over ceiling are themselves unallowable, they are still used as part of the total cost input base for computing G&A expense. As explained in Attachment A, this procedure is simply a mechanism to allocate G&A expenses to final cost objectives.

The standard requires that items produced for stock be included in the input base at the time of production. Therefore, stock items which are in inventory when the standard becomes applicable will not be allocated their share of G&A. To remedy this situation items produced for stock and included in the inventory on the date the standard becomes applicable should be included in the G&A base in the period the items are assigned to final cost objectives.

ATTACHMENT A

THE EFFECTS OF CAS 410 UPON THE ALLOCATION AND
ALLOWABILITY OF G&A EXPENSES

CAS 410.50(f) states "Cost input shall include those expenses which by operation of this standard are excluded from the G&A expense pool and are not part of a combined pool of G&A expenses and other expenses allocated using the same allocation base."

The illustration contained in 410.60(c)(4) states "Business Unit C has accounted for and allocated IR&D/B&P costs in a cost pool separate and apart from the G&A expense pool. C may continue to account for these costs in a separate cost pool under the provision of this standard. If C is to use a total cost input base, these costs when accounted for and allocated in a cost pool separate and apart from the G&A expense pool will become part of the total cost input base used by C to allocate the G&A expense pool."

The above cited sections of CAS require that IR&D and B&P, or any other cost for that matter, which is distributed in a way that is different from the way in which G&A is distributed, must itself become part of the total G&A input base. For example, an IR&D/B&P base that omits major subcontracts or service contracts that are included in the G&A base would be a different base. When that situation pertains, the procedure to be followed is:

- a. distribute all IR&D/B&P to contracts including amounts of IR&D/B&P which are unallowable because they exceed a previously agreed ceiling limitation.
- b. distribute G&A expense to contracts on a cost input base which includes the IR&D/B&P in a, above.

At this point it would appear that the G&A expense which was drawn to a contract by the unallowable amounts distributed in a, above would also be unallowable. The language of DAR 15-203(c) supports this view in its statement that, "...Once an appropriate base for the distribution of indirect costs has been accepted, such a base shall not be fragmented by the removal of individual elements. Consequently, 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."

Although the combination of the CAS required distribution and 15-203(c) would seem to lead to the conclusion that the G&A expense attracted to contracts by unallowable IR&D/B&P dollars would, in itself, be unallowable, it must be recalled that, prior to the issuance of CAS 410, DAR 15-203(c) existed in combination with DAR 15-205.35(b). That subparagraph defines the composition of IR&D costs to "...include not only all direct costs, but also all allocable indirect costs except that general and administrative costs shall not be considered allocable to IR&D."

The combined effect of these two DAR provisions was that no G&A expense was allocated to IR&D/B&P and, therefore, it was not necessary to disallow G&A due to IR&D/B&P expense being disallowed. That intent was not changed by CAS 410 since the CAS Board indicates in its prefatory comment 3(b) to the standard that the G&A expense allocation is considered to be an allocation to a final cost objective, i.e., the contract, and that the IR&D/B&P included in the base dollars is only there as part of the allocation mechanism. It is not to be considered a final cost objective in and of itself. Therefore, the CAS standard does not mandate that the G&A expense attracted by dollars representing unallowable IR&D/B&P be disallowed. Allowing these G&A dollars is DOD's procedure. It accomplishes substantially the same result as presently contemplated by DAR.

This concept raises a broader question as to whether G&A expense related to unallowable base cost of a type other than IR&D/B&P is also allowable under CAS 410. The answer to that resides in the next to last paragraph of prefatory comment no. 4 relative to CAS 405. That paragraph indicates the CAS Board's understanding that the allowance or disallowance of these costs is subject to the cognizant agency's cost principles.

The following model attempts to illustrate the effects of these factors:

- a. treatment prior to and under CAS 410
- b. an allocation base for IR&D/B&P that differs from the base for allocation of G&A
- c. unallowable IR&D/B&P costs
- d. other unallowable costs

The model is based on the following assumptions:

1. There are three contracts each incurring costs of:

Labor	\$200,000
Burden	400,000
Material	150,000
	<u>\$750,000</u>

2. There is a company-wide General & Administrative Expense Pool of \$300,000.
3. There is a company-wide IR&D/B&P Pool with expenditures of \$750,000. The pool is subject to a ceiling of \$500,000.
4. \$50,000 of unallowable material changes are properly allocable to Contract #1.
5. Contract #2 is a services contract and is not part of the contractor's IR&D/B&P Base.

PRE-CAS 410

Attachment A

	Total Costs Incurred	Contract #1		Contract #2		Contract #3	
		Allocated	Paid	Allocated	Paid	Allocated	Paid
Labor	\$ 600,000	\$ 200,000	\$ 200,000	\$ 200,000	\$ 200,000	\$ 200,000	\$ 200,000
Burden	1,200,000	400,000	400,000	400,000	400,000	400,000	400,000
Material	450,000	150,000	100,000	150,000	150,000	150,000	150,000
S-T	\$2,250,000	\$ 750,000	\$ 700,000	\$ 750,000	\$ 750,000	\$ 750,000	\$ 750,000
IR&D	750,000	375,000	250,000	-0-	-0-	375,000	250,000
S-T	\$3,000,000	\$1,125,000	\$ 950,000	\$ 750,000	\$ 750,000	\$1,125,000	\$1,000,000
G&A	300,000	100,000	93,335	100,000	100,000	100,000	100,000
	<u>\$3,300,000</u>	<u>\$1,225,000</u>	<u>\$1,043,335</u>	<u>\$ 850,000</u>	<u>\$ 850,000</u>	<u>\$1,225,000</u>	<u>\$1,100,000</u>

G&A Rate:
 $\frac{300,000}{2,250,000} = 13.33\%$

	Contract #1	Contract #2	Contract #3	Total
G&A Paid Computation				
Total Labor Mat'l & Burden Incurred	\$750,000	\$750,000	\$750,000	\$2,250,000
Less Unallowable Mat'l G&A Base	50,000	-0-	-0-	50,000
X Rate 13.33%=G&A Paid	<u>\$700,000</u>	<u>\$750,000</u>	<u>\$750,000</u>	<u>\$2,200,000</u>
G&A Not Paid Computation: Unallowable Material	\$ 93,335	\$100,000	\$100,000	\$ 293,335
X G&A Rate 13.33%	<u>\$ 50,000</u>			<u>\$ 50,000</u>
	<u>\$ 6,665</u>			<u>\$ 6,665</u>

Attachment A

POST-CAS 410

Total Costs	Contract #1		Contract #2		Contract #3	
	Allocated	Paid	Allocated	Paid	Allocated	Paid
Labor \$ 600,000	\$ 200,000	\$ 200,000	\$ 200,000	\$ 200,000	\$ 200,000	\$ 200,000
Burden 1,200,000	400,000	400,000	400,000	400,000	400,000	400,000
Material 450,000	150,000	100,000	150,000	150,000	150,000	150,000
S-T \$2,250,000	\$ 750,000	\$ 700,000	\$ 750,000	\$ 750,000	\$ 750,000	\$ 750,000
IR&D 750,000	375,000	250,000	-0-	-0-	375,000	250,000
S-T \$3,000,000	\$1,125,000	\$ 950,000	\$ 750,000	\$ 750,000	\$1,125,000	\$1,000,000
G&A 300,000	112,500	107,500	75,000	75,000	112,500	112,500
<u>\$3,300,000</u>	<u>\$1,237,500</u>	<u>\$1,057,500</u>	<u>\$ 825,000</u>	<u>\$ 825,000</u>	<u>\$1,237,500</u>	<u>\$1,112,500</u>

G&A Rate:
 $\frac{\$ 300,000}{\$ 3,000,000} = 10\%$

G&A Paid Computation:		Contract #1	Contract #2	Contract #3	Total
Labor, Mat'l & O/H Incurred		\$ 750,000	\$ 750,000	\$ 750,000	2,250,000
Less: Unallowable Material		50,000	-0-	-0-	50,000
		<u>\$ 700,000</u>	<u>\$ 750,000</u>	<u>\$ 750,000</u>	<u>2,200,000</u>
Plus Gross IR&D		375,000	N/A	375,000	750,000
X 10%=G&A Paid		<u>\$1,075,000</u>	<u>\$ 75,000</u>	<u>\$1,125,000</u>	<u>2,950,000</u>
		<u>\$107,500</u>	<u>\$ 75,000</u>	<u>\$112,500</u>	<u>295,000</u>
G&A Not Paid: Unallowable Other Than IR&D		\$ 50,000			50,000
X 10% G&A Rate = G&A Not Pd		<u>\$ 5,000</u>			<u>5,000</u>

Attachment A

ANALYSIS OF PRE & POST 410 DIFFERENCES

	<u>Contract # 1</u>	<u>Contract #2</u>	<u>Contract #3</u>	<u>Total</u>
Amount Paid before 410	<u>\$1,043,335</u>	<u>\$ 850,000</u>	<u>\$1,100,000</u>	<u>\$2,993,335</u>
Amount Paid under 410	<u>\$1,057,500</u>	<u>\$ 825,000</u>	<u>\$1,112,500</u>	<u>\$2,995,000</u>
Increase or (decrease)	<u>\$ 14,165</u>	<u>\$ (25,000)</u>	<u>\$ 12,500</u>	<u>\$ 1,665</u>

Analysis of Changes:

	<u>Contract #1</u>	<u>Contract #2</u>	<u>Contract #3</u>	<u>Total</u>
Due to Inclusion of all IR&D in the G&A Base	\$ 12,500	\$ (25,000)	\$ 12,500	\$ -0-
Due to lower G&A rate on Unallowables as a result of including all IR&D in the G&A Base	<u>\$ 1,665</u>	<u>-0-</u>	<u>-0-</u>	<u>\$ 1,665</u>
Total Increase or (Decrease)	<u>\$ 14,165</u>	<u>\$ (25,000)</u>	<u>\$ 12,500</u>	<u>\$ 1,665</u>

29 March 1977

WG 77-12

SUBJECT: Interim Guidance - Deliberate Noncompliance and Inadvertent
Noncompliance

References: WG 76-8
DAR 3-1212
DAR 3-1214

Background

Paragraph (a)(5) of the CAS Clause requires an adjustment of contract price or of cost allowance if increased costs to the Government occur because the contractor fails to follow disclosed practices or cost accounting standards. Increased costs plus interest are to be recovered. Paragraph (g) of 4 CFR 331.70 Interpretation, provides, however, that if the failure to follow Standards or disclosed practices is inadvertent, it is only necessary to recover the difference between cost increases and cost decreases plus interest.

The significance of 4 CFR 331.70(g) is that deliberate noncompliances are treated differently from inadvertent noncompliances. Thus, when deliberate noncompliance takes place, the contractor must repay excess costs plus interest on each CAS contract which has experienced increased costs due to noncompliance. And, there can be no offset against CAS contracts which may have experienced decreases as a result of deliberate noncompliance. On the other hand, if the noncompliance was inadvertent, the increased costs may be offset to the extent the noncompliance results in decreased costs on other CAS contracts. (See WG 76-8 for discussion of the use of offset in contract adjustment).

Discussion

Clearly, in a noncompliance situation, it will be in the contractor's interest to label the noncompliance as inadvertent, because it will minimize his cost liability to the Government through use of offset. While it is not possible to anticipate the many kinds of case histories ACOs will be required to judge, some basic questions can be discussed.

For example, if a contractor noncomplies with a disclosed practice or Standard, can it be concluded that, because he had knowledge of the requirements of the Standard or the disclosed practice, he is precluded from using the excuse of inadvertence? The answer is no. He can claim inadvertence provided he demonstrates that the noncompliance resulted from failure of his employees to follow company policy and instructions. He should be required to demonstrate, however, that policy and instructions were made known to concerned employees and, that there was a good faith effort on his part to implement those policies.

A situation might also arise when an ACO finds a noncompliance, known to the contractor, brings it to the attention of the contractor and convinces him that a noncompliance truly exists. In this example, the noncompliance should also be considered inadvertent.

ACOs may encounter situations in which similar noncompliances, any one of which would not be considered deliberate in and of itself, occur frequently. A sufficiently repetitious pattern would support a conclusion that the violations were deliberate. The materiality of the total occurrences should also be considered.

Another situation arises when the contractor and ACO are not in agreement regarding the contractor's compliance with a Standard and the case goes to the Armed Services Board of Contract Appeals (ASBCA). If the contractor appeals the ACO decision, and ultimately wins, there is no problem; because he will have been found to be in compliance. But, what if he loses? One solution would be to consider the noncompliance inadvertent on the basis that the contractor fully believed he was in compliance. It could be argued that this would encourage appeals to the ASBCA, whether they have merit or not, and a case might be made that contractors should bear the risk of such appeals because if they win they suffer no loss. If they lose, they accept the result of deliberately noncomplying. However, this approach may be overly harsh. On balance, it appears more reasonable to consider noncompliances to be inadvertent when appeals are taken, unless it is determined that the appeal is based on grounds that are clearly frivolous. Generally, the time and cost involved in taking appeals to the ASBCA is adequate protection from abusing this remedy just to avoid the effect of deliberate noncompliances. At the same time, it appears reasonable to assume that the CAS legislation and the CAS Board's rules are primarily intended to protect the Government, not penalize contractors by extracting from them, costs that are otherwise reasonable and allowable.

A different example would be when a contractor is in noncompliance with disclosed practices, because he has changed an accounting practice and failed to advise the ACO as required. If the contractor subsequently takes necessary action to establish the change in accordance with DAR 3-1214 and the contract clause in 7-104.83(b) what should the ACO do about the period preceding the contractor's notification and the ACO's determination as to adequacy and compliance? There is no doubt the contractor deliberately intended to follow the new practice rather than that in his established disclosure statement. In this case, there appears to be no excuse for the contractor to go ahead with a change and not give notice to the ACO as required. Deliberate noncompliance seems to be the only reasonable determination that could be made for this period.

Guidance

Contractors should be notified at the earliest practicable time whether noncompliances are considered to be deliberate or inadvertent.

Deliberate noncompliance should be determined when a contractor has not made a reasonable effort to acquaint responsible management and other affected personnel of the requirements of CAS and has not established appropriate policies for carrying out these requirements as established in pertinent contract and DAR provisions. When reasonable effort has been made by the contractor and noncompliance takes place, the ACO, generally, should determine the noncompliance to be inadvertent.

Inadvertent noncompliance should also be the finding when a previously unrecognized noncompliance comes to light and the contractor takes action to make the correction.

Repetitive noncompliances of like or similar character would constitute persuasive evidence in support of a determination that the noncompliance was deliberate.

Noncompliances which are formally appealed, and the appeal is subsequently denied by the Board of Contract Appeals, should be considered inadvertent except in cases where it is determined that the appeal is based on grounds which are clearly frivolous.

Voluntary changes in accounting practices should normally be considered deliberate noncompliances when they are implemented earlier than 60 days after the time the ACO has received notice as provided in DAR 3-1214. (A different time period may be mutually agreed to by the ACO and contractor.) Following this time period they should be considered as voluntary changes, or if the ACO determines the changes to be noncompliant, they shall be considered as inadvertent noncompliances.

29 March 1977

WG 77-13

SUBJECT: Interim Guidance on the Applicability of CAS 405 to Costs
Determined Unallowable on the Basis of Allocability

Background

CAS 405 provides that a contractor must identify unallowable costs. Specifically, paragraph 405.40(a) provides that:

"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 unallowable cost is defined in paragraph 405.30(a)(4) as:

"Any cost which, under the provisions of any pertinent law, regulation, or contract, cannot be included in prices, cost reimbursements, or settlements under a Government contract to which it is allocable."

It has been suggested that the last five words of paragraph 405.30(a)(4), "...to which it is allocable." can be interpreted to mean that CAS 405 does not apply to costs determined unallowable by the Government on the basis of allocability, and thus a contractor is not required to identify such unallowables.

Discussion

It is the intent of the Cost Accounting Standards Board that CAS 405 apply to all costs determined unallowable, including those so determined on the basis of allocability. This intent is consistent with the standard's purpose as stated in paragraph 405.20 of the standard. Thus, the definition of an "unallowable cost" applies to any cost which a contractor assigns to Government contracts which is determined to be unallowable for whatever reason; i.e. law, regulation, contract terms, or allocability.

Going one step further, assume that a contractor proposes a cost on a contract and it is questioned solely on the basis of allocability. The contractor has two options: (1) he can agree with the Government that the cost is not properly allocable and, therefore, unallowable, or (2) he can claim that the cost is allocable and, therefore, allowable. In the first case the cost is unallowable by mutual agreement and in accordance with CAS 405.40(a) must be identified. In the second instance, if both parties hold their ground and the cost becomes the subject of a dispute, then in accordance with CAS 405.40(b) it becomes designated as unallowable and must be identified if used in computing any billing claim for the contractor to claim that the cost is allocable while simultaneously claiming that he does not have to identify it per CAS 405 because it is not allocable.

Guidance

Contractors should be required to identify all unallowable claimed costs in accordance with CAS 405, including costs determined unallowable by the Government on the basis of allocability. If a contractor refuses to identify unallowable costs, including those determined not allocable, the contractor is in noncompliance and the procedures set forth in DAR 3-1212 should be followed.

29 March 1977

WG 77-14

SUBJECT: Interim Guidance on Early Implementation of New Cost Accounting Standards Issued by the CAS Board

Background

Interim Guidance Paper WG 76-7, provided guidance on the "effective date" and the "applicability date" of a new standard. With regard to contractor's proposals, WG 76-7 stated that contract effort occurring after the effective date but before the applicability date should be priced using the contractor's old accounting practice. Effort projected to occur on or after the applicability date, should be priced in compliance with the new standard. Also, equitable adjustment for those CAS-covered contracts in existence when a standard becomes effective should cover the period from the date the standard becomes applicable through contract completion.

The purpose of this paper is to deal with situations when contractors wish to implement new standards before they become applicable.

Discussion

Generally, two opposing approaches have been proposed. First is the proposal that contractors should be allowed to implement a new standard any time after its effective date and be entitled to an equitable adjustment, even though the mandatory implementation (applicability) date has not passed. The opposite proposal is that early implementation of new standards must be considered a voluntary change and, therefore, the Government should not pay any increased costs resulting from the changed practice.

Neither of the two extreme positions is appropriate. In the first position, the Government does not incur an obligation to pay increased costs for effort prior to the applicability date; consequently the contractor is not entitled to equitable adjustments (i.e., increased costs) for the period between the effective date and the applicability date. The second position prohibits the contractor from receiving an equitable adjustment for that period running from the applicability date of the standard to completion of the contract, merely because he had implemented the change before the applicability date. This is inequitable and unnecessarily restrictive.

Guidance

Unless precluded by contract provision, a contractor may implement a new Cost Accounting Standard on or after its effective date, but prior to its applicability date. In this instance the following guidance is applicable:

a. The change will be administered as a voluntary change prior to the applicability date. No increased costs to the Govt incurred during this period will be allowed.

b. The contracting parties will be entitled to an equitable adjustment for those effects of the change which impact existing contracts on or after the applicability date.

In summary, contractors may implement new standards early, but the Government will not pay increased costs that occur prior to the applicability date.

29 March 1977

WG 77-15

SUBJECT: Interim Guidance on the Influence of CAS Regulations on Contract Terminations

Background

It is reasonable to expect with the passage of time that more and more contracts being terminated will be CAS-covered contracts. Questions have arisen as to whether there is a conflict between DOD's heretofore normal termination cost practices as primarily described in DAR 12-205.42 and CAS Board Regulation, particularly Standards 401, 402, and 406.

Discussion

CAS 401 generally requires that costs be accumulated and reported in the same way that they have been estimated. Since the cost estimates leading up to the signing of a contract are ordinarily predicated upon the contract being performed to completion, many of the costs contained in the termination claim are likely to be arranged in ways that are quite different from the cost presentation contained in the original estimate.

Under the requirements of CAS 402 "like costs" in "like circumstances" must be consistently classified as either direct only or indirect only. Under DAR 15-205.42, termination claims will often include costs such as settlement expenses, unexpired lease costs, etc. as direct charges while those costs or functions would have been charged as indirect costs if the contract had run its course.

DOD's view is that normal termination procedures violate neither CAS 401 or 402. The termination of a contract creates a situation that is totally unlike the completion of a contract. It is not reasonable or logical to extend the requirement for consistency with an estimate to an event which was never anticipated in the estimate. The consistency requirement would be violated, however, if a contractor had several similar terminations and handled them in dissimilar ways. It may be advisable for a contractor to document his termination accounting procedures as a part of his disclosed practices. The circumstances usually associated with a termination also mitigate the requirements of CAS 402 since the "like circumstances" referred to in the Standard are generally lacking.

Another concern has been expressed as to whether CAS 406 conflicts with the suggestion contained in DAR 15-203(e)(i) that a period shorter than a year may be proper for indirect cost rate computations when contract performance involves only a minor portion of the year. CAS 406 requires that a contractor use his fiscal year as his cost accounting period. CAS 406 does, indeed, prohibit the use of a shorter accounting period for CAS-covered contracts. It has generally been DOD's policy to employ full year indirect cost rates or

annualized representations of the same. That policy is now a requirement. This means that a contract terminated and settled early in an accounting year may use an estimate of overhead for the remainder of the year that together with the incurred historical costs represents a full fiscal year.

DOD believes that contrary to the notion that Cost Accounting Standards conflict with and overrule our termination procedures, the Standards tend to support them. In CAS 410.50(j), for example, when a final cost objective benefits significantly more or less from G&A than the normal allocation would reflect, a special allocation to the particular final cost objective is advocated. Both the special pool and base are then to be excluded from the overall G&A rate computation. CAS 403 and 405 are also supportive of normal termination procedures in their advocacies of allocation methods reflecting causal and beneficial relationships and direct associations of costs.

Guidance

Normal DOD termination costing procedures as detailed in DAR 15-205.42 are still in effect. Termination Contracting Officers should assure themselves that within the context of termination situations consistency is honored to the extent that circumstances are similar. Overhead Rates must represent a full accounting period.

14 June 1977

WG 77-16

SUBJECT: Interim Guidance on Applicability of Cost Accounting Standards
to Letter Contracts

Background

The Cost Accounting Standards (CAS) clause (DAR 7-104.83(a)) provides, in part, the following requirement:

....Comply with all Cost Accounting Standards in effect on the date of award of this contract or if the contractor has submitted cost or pricing data, on the date of final agreement on price as shown on the contractor's signed certificate of current cost or pricing data....

Questions have arisen regarding the application of CAS to letter contracts. First, does CAS apply to letter contracts, and if so, when? Second, what significance does definitization of a letter contract have?

Discussion

Does CAS apply to letter contracts? Letter contracts are not specifically commented on in Public Law 91-379, CASB promulgations or DAR sections relating to CAS. DAR Section VII, Part 8, include all clauses known to be appropriate for the definitive contract which is contemplated. The CAS clause at DAR 7-104.83(a) provides, in part, that CAS applies as of the date of award or on the date of final agreement on price as shown on the signed certificate of current cost or pricing data, unless the contract would otherwise be exempt. Since certified cost or pricing data is not normally submitted prior to the award of a letter contract, the awarding of the letter contract (if the definitized contract should be subject to CAS) would require inclusion of the CAS clause and be subject to CAS requirements at contract inception.

What is the significance of the definitization of a letter contract? Definitization of a letter contract is a contract modification not a new award; therefore, definitization would not trigger (activate) Standards issued subsequent to the letter contract award date.

Guidance

CAS is applicable to letter contracts as of the date of award unless it has been determined that the contract is excluded under one of the exemptions from CAS requirements. Definitization of the contract would not trigger (activate) any new Standards since definitization is a contract modification rather than a new contract. (See Interim Guidance Paper WG 76-2).

SUBJECT: Identification of CAS Contract Universe at a Contractor's Plant

Background:

Whenever a contractor makes a change to his disclosed or established accounting practices or is determined to be in noncompliance, the Administration of CAS clause, DAR 7-104.83(b), requires him to submit a cost impact proposal. An integral part of the cost impact proposal is the list of CAS-covered contracts and subcontracts which will be affected by the change or noncompliance.

Discussion:

The General Accounting Office (GAO), in its final report, entitled "Status Report to the Congress on the Cost Accounting Standards Program - Accomplishments and Problems," found that auditors were spending an inordinate amount of time verifying the completeness and accuracy of the lists submitted by contractors. The GAO recommended that the DoB develop a procedure for identifying all the CAS-covered contracts and subcontracts at a particular contractor's plant.

Inherent in the Administration of CAS clause is the responsibility of a contractor to supply accurate and complete lists of his CAS-covered business. However, to preclude any misunderstanding and a consequent loss of time, the following guidance is provided.

Guidance:

In order to comply with the requirements of the Administration of CAS clause, DAR 7-104.83(b), contractors should be required to maintain a system for identifying accurately and completely all contracts and subcontracts which contain the Cost Accounting Standards clause, 7-104.83(a). The ACO should ensure that the contractor has such a system and that it is functioning effectively.

SUBJECT: Interim Guidance for Implementation of Cost Accounting Standard 414 - Cost of Money as an Element of the Cost of Facilities Capital; and DPC 76-3

I. Background:

Cost Accounting Standard 414 establishes criteria for the measurement and allocation of the cost of capital committed to facilities as an element of contract cost. DAR 3-1300, (Item II, DPC 76-3), extends the CAS 414 procedures to all contracts negotiated on the basis of cost analysis; DAR 15-205.50 makes the cost of money, when computed in accordance with CAS 414, an allowable contract cost. The effective date of this Standard and the provisions of DPC 76-3 is October 1, 1976. Contractors and subcontractors must follow the requirements of both regulations on all CAS contracts and subcontracts which are negotiated on or after this date.

In accordance with section 414.70 of the Standard, it does not apply if either the contract award date or the date of final agreement on price as shown on the certificate of current cost or pricing data precedes October 1, 1976. However, DPC 76-3 as modified by the memorandum of September 17, 1976, may apply the techniques of CAS 414 to contracts that existed prior to October 1, 1976. In these cases, the techniques may be applied to contract modifications which price contract line items not previously priced, provided such work is performed after October 1, 1976. This includes repricing actions under type A price redeterminations. It should be noted that use of the 414 techniques for these modifications requires mutual agreement of the parties and thus is appropriate only when consideration flows to both parties as a result of the use of the technique.

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. In other words, the cost of money may be considered to be an indirect expense associated with an individual cost pool but separately identified. Like all indirect expenses, the cost of money is subject to all the same allocation procedures as any other expense which is allocable to the selected allocation base, and each element of such base, whether allowable or unallowable, should bear its prorata share of the cost of money.

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 overhead rates.

Facilities capital included in the cost of money computation includes tangible and intangible capital assets that generate allowable depreciation or amortization as well as land which is integral to the regular operation of the business unit, and leased property for which constructive costs of ownership are allowed in lieu of rental costs under Government procurement regulations. The treatment of leased property under CAS 414 is not addressed in this interim guidance paper. This subject will be discussed in a subsequent paper.

CAS 414 and DAR 15-205.50 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. Also, CAS 414 provides that to be included in the base for the cost of money calculation, the asset must be used in the regular business activity, and DAR 15-205.50(a) states the base for cost of money is facilities capital employed in support of defense contracts. These latter criteria serve to eliminate items such as the following from the cost of money computation:

1. Land held for speculation or expansion.
2. Facilities or facility capacity which have been determined to be excess or idle in accordance with DAR 15-205.12.
3. Assets which are under construction or have not yet been put into service.

II. Application of Cost of Money to IR&D and B&P Expense

A. Discussion:

Questions have arisen concerning the application of cost of money to IR&D and B&P projects.

To be decided are:

1. Is the cost of money to be considered part of or allocable to, the ceiling?
2. Is the cost of money associated with over ceiling IR&D and B&P expense to be allowable?
3. Is the cost of money associated with G&A expense allocable to IR&D and B&P expense?

DAR 15-205.3 and 15-205.35 govern the composition, allocation, and allowability of IR&D and B&P costs. More specifically, DAR 15-205.3(b) and 15-205.35(b) state that "Both direct and indirect costs shall be determined on the same basis as if the IR&D (or B&P) project were under contract." It, therefore, follows that the cost of money is allocable to IR&D and B&P projects and should be allocated to final cost objectives in the same manner as the IR&D and B&P expense.

A question has been raised as to whether the cost of money should be included in the total ceilings negotiated for IR&D and B&P. If this is done, the ceilings would not be comparable to previous ceilings which did not include these costs, and it would be necessary to increase the

ceiling by the amount of the cost of money applicable if the same level of IR&D/B&P effort is to be supported.

Another factor bearing on this issue is the fact that the CAS Board is currently developing new Cost Accounting Standards for IR&D and B&P. These Standards are expected to require changes in the method of accounting for IR&D/B&P expenses. This change, following close behind the CAS 414 change, would require two successive revisions in the method of accounting for IR&D/B&P. Under the circumstances it appears appropriate to continue the present method of establishing IR&D/B&P ceilings (excluding cost of money) and incorporate the effect of both the cost of money and the new Standards on IR&D and B&P at the time the effect of the IR&D/B&P Standards are known. To accommodate CAS 414 during this interim period, it will be necessary to obtain agreement with the contractor that while the cost of money is not included in the ceiling dollars, such costs are to be allocated, and the portion associated with allowable IR&D/B&P shall also be allowable. It should be noted, however, that the cost of money associated with G&A expense should be allocated as though it were G&A expense (see Interim Guidance Paper W.G. 77-11).

B. Guidance:

1. The cost of money is allocable to IR&D and B&P and the total allocable amount should be accounted for separately and not included in the established ceiling. However, there must be an understanding that:

a. The cost of money allocable to unallowable IR&D and B&P (amount over ceiling) shall be considered unallowable.

b. Cost of money allocable to the allowable IR&D and B&P shall be allocated to contracts over the same base used to allocate the IR&D and B&P expense.

2. Cost of money which is attributable to G&A expense shall be allocated using the procedures set forth in W.G. 77-11.

III. Revised Disclosure Statement

A. Discussion:

Under CAS 414 the regular method of computing the cost of money is preferred. The alternate method is available if the contracting parties can agree that the results of either method will be substantially the same. Although a contractor should decide which method he will use, and follow it consistently, a change from one to the other should not have a significant monetary impact and contract adjustments should not be required.

A further option that a contractor may make, for administrative ease, is to include, or exclude, the cost of money in the G&A allocation base. Once an option is selected, a change from one to the other should be considered a voluntary accounting change. The initial completion of the CMF form should serve as a baseline for the contractor's established practices for compliance with CAS 414.

It could be argued that since the CAS 414 preferred regular method requires the cost of money to be allocated by the same method as depreciation, the contractor's current disclosure statement provides adequate visibility.

Moreover, the CAS Board disclosure statement does not expressly require the disclosure of the practices used by the contractor to determine and assign the cost of money. However, the cost of money calculation is a significant accounting matter, and an adequate description of the practices involved are virtually mandatory to ensure an understanding of the accounting methods relating to this new cost element. Notwithstanding the appearance that the CAS 414 procedures are already disclosed in connection with other cost elements, there appears to be sufficient leeway in CAS 414 for contractors to use methods other than those disclosed for depreciation even under the "regular" method.

B. Guidance:

1. The contractor should be requested to revise his disclosure statement to include the procedures related to CAS 414. This revision may be a single statement to the effect that the contractor will use the same procedures used in identifying and allocating depreciation to final cost objectives and that land will be assigned in the same manner as the facilities to which it relates. The contractor should be required to amend his disclosure statements to include the procedures to be used in determining the cost of money when the CAS 414 procedures are expected to vary from those used to measure, assign and allocate depreciation.

2. The contractor should disclose whether he will use the regular method and whether he will attempt to justify the use of the alternate method. Further, he should disclose whether he will include the cost of money in the G&A allocation base or not. Once an option is selected, a change from one to the other should be considered a voluntary change.

The following is an example of how the contractor's disclosure statement revision might be made:

4.1.0(n) [Y]
4.2.0(n) [Y]
4.3.0(1) [Y]
4.5.0 Continuation sheet.

The cost of money is computed in accordance with the procedures set forth in CAS 414. We identify assets, calculate net book values, assign net book value to indirect cost pools and reallocate undistributed net book values to indirect cost pools by the same procedures as are used to identify and allocate depreciation to final cost objectives.

For any accounting period in which it can be demonstrated, and the ACO agrees that no substantial difference will result, we will estimate, accumulate and report by using the alternative method as described in CAS 414.

4.6.0 Continuation Sheet

The cost of money is allocated to final cost objectives over the same base unit of measure as is used to allocate the other indirect expenses included in the cost pool to which the cost of money is related.

For all accounting periods, whether the regular or alternative method is used we estimate, accumulate and report by including the cost of money in the cost input base used to allocate G&A expense to final cost objectives.

IV. Application of CAS 414 to Price Proposals

A. Discussion:

The fundamental concept of using current, accurate, and complete data in pricing proposals applies equally to data used to compute proposed cost of money. Thus, historical or forecasted costs used in pricing cost of money in proposals must represent the best available information

The Secretary of the Treasury determines the cost of money rate to be used in computing the cost of money factors pursuant to Public Law 92-41. The rate published in December is to be used from 1 January through 30 June; the rate published in June should be used from 1 July through 31 December.

In calculating final overhead rates, the Standard provides that the cost of money rate be the average of the rates in effect during

assumption contractors make when proposing indirect expenses using an unadjusted, experienced overhead rate. The assumption that a constant factor will be appropriate rests upon the three variables involved in the cost of money computation: the interest rate, the net book value of facilities capital, and the allocation base. Even minor changes in the interrelationship of any of these variables may substantially affect the cost of money factor.

The Standard requires that the latest available semi-annual interest rate be used for estimating purposes and this rate should be compared to the historical average. Known and anticipated additions and deletions of assets will require close examination to determine the affect on the factors. The effect of the annual depreciation on an unchanged level of facilities employed will reduce the net book value sufficiently to make the historical factors inappropriate. The allocation bases used in the cost of money computation should be consistent with those used in estimating overhead rates. Mere inflation could significantly change the relationship of the base to the imputed cost of money since the net book values are less subject to inflation.

Under the projected method, the cost of money factors will be based on the latest available cost of money rate and a forecast of the facilities net book value and allocation base for each cost accounting period of contract performance. This method should be used when the contractor can reasonably demonstrate that there will be major fluctuations in the levels of facilities employed or the allocation base to be experienced by the business unit during contractor performance. The interest rate which will be in effect at the conclusion of the negotiation and applied to the contractor's estimate may not be known when the audit report is written, or when the negotiation begins. Accordingly, care should be exercised to assure that the most recent interest rate published by the Secretary of the Treasury is considered.

B. Guidance:

1. If a contractor does not propose the cost of money, which would be allocable to the resultant contract, the PCO should specify in the contract terms that cost of money will not be allowable as an element of cost under the contract. In no event may the cost of money as computed in accordance with the procedures set forth in CAS 414 be included in profit.
2. When there is no increase in cost paid or to be paid as a result of a noncompliance with CAS 414, a determination of noncompliance need not be issued. The contract auditor should not be expected to issue a noncompliance report unless specifically requested by the ACO.
3. A careful review should be made before the historical method is accepted for pricing future work, because the historical method may result in a cost of money factor substantially higher than that which will actually be experienced.

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page 8

4. When a new interest rate is determined prior to or during negotiations, the PCO should consider recomputing the cost of money amount before finalizing negotiations.

CAS STEERING COMMITTEE INTERIM GUIDANCE

W.C. 77-19
18 August 1977

SUBJECT: Administration of Leased Facilities Under Cost Accounting Standard 414, Cost of Money as an Element of the Cost of Facilities Capital

References: a. W.C. 77-18
b. DAR 15-205.34, 15-205.48 and 15-205.50
c. DPC 76-3

BACKGROUND

Cost Accounting Standard 414 provides that the cost of money will be computed on the average net book value of facilities capital items, including certain leased facilities, for which constructive cost of ownership is allowed in lieu of rental costs under government procurement regulations.

DISCUSSION

Two major issues have been raised regarding the implementation of Standard 414 in administering leased facilities: (1) whether to recognize cost of money as a part of constructive ownership cost in determining whether allowable cost will be based on constructive cost of ownership or rental costs, and (2) when to include the net book value of leased assets on the CASB-CMF form.

(1) Whether to Recognize Cost of Money as Constructive Ownership Cost. Cost of money is a cost which the contractor would be allowed if he had purchased the property. Therefore, it should be included as an ownership cost in making the determination whether allowable cost will be based on constructive cost of ownership or leasing costs. After that determination, cost of money should be allowed as a separate item under DAR 15-205.50 and not included as a constructive ownership cost in determining allowable cost under DAR 15-205.34 and 15-205.48 for each accounting period.

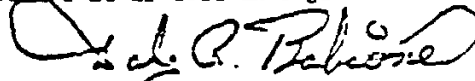
(2) When to Include the Net Book Value of Leased Assets on the CASB-CMF Form. Timing for including net book value of leased assets on the CASB-CMF form involved at least two possibilities: (i) at the beginning of the lease term, or (ii) at the time when cumulative leasing cost exceeds cumulative cost of ownership, commonly referred to as the "cross-over point".

(i) Beginning of the Lease. This is the period selected for reflecting the net book value of leased assets on the CASB-CMF form. By including the net book value on the form from the beginning of the lease term, average asset values can be shown for all cost accounting periods during which the asset is used. This procedure is in accord with present requirements at DAR 15-205.34 and 15-205.48 which require that constructive ownership costs be computed from the beginning of the lease term in order to determine the allowability of leasing cost. The procedure is also in accordance with recently issued, generally accepted accounting principles (Financial Accounting Standards Board Statement #13) when capitalization of leases is required for financial reporting purposes.

(ii) "Cross-Over Point". This period for reflecting the net book value of leased assets on the CASB-CMF was considered but rejected for several reasons. Average asset values would not be shown on the form during early cost accounting periods, and would not be part of the profit base during those periods. Contractors would not receive cost of money allowance commensurate with the value of the asset consumed during its use. Selection of the "cross-over point" would not be in conformance with generally accepted accounting principles when capitalization of leases is required for financial reporting purposes.

GUIDANCE

1. Cost of money should be included as an ownership cost in making the determination whether allowable cost of leased facilities will be based on constructive cost of ownership or leasing costs.
2. Where it has been determined that to allow leasing cost is more advantageous to the government, the value of the leased facilities will not be included in the cost of money as a cost of facilities capital computation.
3. Leased assets for which a decision has been made to limit reimbursement to constructive cost of ownership under DAR 15-205.34 and 15-205.48 will be included on CASB-CMF form at their net book value computed at the effective date of Standard 414 or at the beginning of the term of the lease whichever is later.
4. Net book values, for the purpose of computing a contractor's cost of facilities capital on leased assets shall be computed based on the asset's fair value at the beginning of the term of the lease less an amount equal to accumulated depreciation from the beginning of the term of the lease computed in a manner as if the contractor had purchased the asset. The cost of money will not be included in the net book value of leased assets as reflected on the CASB-CMF form.
5. The cost of money related to leased assets will be allocated to benefiting cost objectives as an integral part of the cost of money factors for all capital assets, as prescribed by Standard 414.
6. Consistent with Interim Guidance paper W.G. 77-18 land will be shown on the CASB-CMF form (at its fair value at the beginning of the term of the lease) for each accounting period it is used in regular business operations.



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SUBJECT: Policy for Withdrawing Determination of Adequacy of Disclosure Statement

Background:

Defense contractors and subcontractors are required, as a condition of contracting, to disclose in writing an adequate description of their cost accounting practices. A Disclosure Statement is considered adequate if it is current, accurate and complete. There is wide confusion as to the right of Government to withdraw the determination of adequacy of disclosed practices when they are no longer considered adequate.

Discussion:

Questions have been raised as to whether the ACO has a right to withdraw an adequacy determination that was previously given. Any consideration of the factors bearing on this question would indicate that he not only has a right, but a duty, to take this action if the statement is determined, at any time, to be inadequate. Failure to do so would relieve the contractor of any requirement to maintain the statement in a current, accurate and complete status after the initial determination of adequacy had been given. This would ultimately render the document completely useless.

A notice to the contractor that his Disclosure Statement is no longer considered adequate will have the effect of making the contractor ineligible to receive new contract awards. This, obviously, will disrupt and delay normal procurement processes and such action should, therefore, not be taken unless it is based on substantive issues. On the other hand, auditors and ACOs should not delay advising contractors of revisions to the Disclosure Statement that may appear necessary even though the issue may not be of such magnitude as to warrant withdrawal of the adequacy determination. It is important that issues not be accumulated over a period of time, to be raised at the time of a new contract negotiation. This will only serve to further complicate and prolong normal procurement procedures.

There is seldom a problem in determining whether a Disclosure Statement is current or accurate. There is a problem in determining whether it is complete. To be complete the statement must contain a level of detail adequate to fully discuss the accounting practices which the contractor employs. At the same time there is no need for burdening the statement with minuscule descriptions of accounting procedures that will have no discernible effect on the flow of costs even if they are changed from time to time.

A determination that the level of detail in a Disclosure Statement is adequate, is judgmental and thus the detail should be expected to vary from contractor to contractor or even between cost centers of a particular contractor depending upon the volume or mix of business or complexity of the accounting system. As the volume increases the mix

changes or accounting procedures become more complex, the Disclosure Statement would be expected to become more detailed.

Materiality appears to be the key word in determining what level of detail should be required. Thus, accounting procedures which, if changed, would not have a material effect on the flow of costs, either now or in the foreseeable future, should probably not be included in the Disclosure Statement.

Guidance:

Materiality should be a major factor in deciding the level of detail required to be disclosed. A prime consideration should be whether a change in accounting procedure at the level of detail under consideration would have a material effect on the flow of costs, now or in the near future.

The level of detail needed to adequately describe the accounting practices will vary depending upon volume or mix of work in the plant or cost center, or complexity of the accounting system.

Contractors should be advised immediately when a revision to the Disclosure Statement is considered necessary.

ACD's do have authority to withdraw an adequacy determination previously given for a Disclosure Statement, but action to withdraw the determination should not be taken unless the issue is material and the contractor will not make the revision.

CAS STEERING COMMITTEE INTERIM GUIDANCE
AMENDMENT 1 TO W.G. 78-21
APRIL 10, 1981

SUBJECT: Implementation of CAS 410, Allocation of Business Unit General and Administrative (G&A) Expenses to Final Cost Objectives

REFERENCE: W.G. 78-21, 16 January 1978

BACKGROUND

W.G. 78-21 provided guidance in response to specific questions which had been surfaced during the implementation of CAS 410. However, questions remain concerning the most appropriate cost input allocation base to be used in the distribution of G&A expenses to final cost objectives. Basically, the underlying issues concerned the answers to Question #3 and Question #5 in W.G. 78-21. Specifically, is total cost input the preferred allocation base (Question #3) and under what conditions would the inclusion of material and subcontract costs in the allocation base distort the assignment of G&A expense to final cost objectives, therefore, requiring selection of the value-added cost input base (Question #5)?

DISCUSSION

QUESTION #3

The question of whether the total cost input allocation base is the preferred base under CAS 410 has been emphasized beyond its relevance to the proper implementation of this standard. Therefore, the guidance contained in W.G. 78-21 is restated as follows.

ANSWER

There is no specific statement of preference in the standard. The standard says, "A total cost input base is generally acceptable as an appropriate measure of the total activity' of a business unit." The prefatory comments say, ". . .the term, total activity' refers to the production of goods and services during the cost accounting period." Thus, unless circumstances exist where a significant difference is apparent between the activity involved in the production of goods and services during the cost accounting period and the costs of such activity, a total cost input base would satisfy the requirements of the standard. When circumstances exist where total cost input does not appear to be an appropriate measure of total activity of the business unit, other bases available in the standard should be considered. The value-added base shall be used where inclusion of material and subcontract costs would significantly distort the allocation and where costs other than direct labor are significant measures of total activity. What constitutes a significant distortion in this context is addressed in Question #5. The criteria for use of a single element cost input base are very specific. The standard says, "A single element cost input base, e.g., direct labor hours or direct labor dollars, which represents the total activity of a business unit may be used to allocate the G&A expense pool where it produces equitable results. A single element

base may not produce equitable results where other measures of activity are also significant in relation to total activity. A single element base is inappropriate where it is an insignificant part of the total cost of some of the final cost objectives."

A perfect reflection of total activity may not be reasonably expected from any of the three cost input bases available in the standard. The selection of a cost input allocation base which best represents total activity must be predicated on an analysis of the relevant circumstances at each business unit. The relevant circumstances considered should be those experienced in a typical cost accounting period rather than unique circumstances existing at one time or within a single accounting period. Purification of the G&A expense pool is a viable approach to minimizing any potential inequities which may surface in implementing the standard.

QUESTION #5

The criteria for establishing the existence of a significant distortion appears to have been confined in practice to the two examples contained in the W.G. 78-21 guidance: Government-furnished components and precious metals. These two examples had not been intended to be all-inclusive as instances where the value-added base must be selected. To illustrate this point the answer to Question #5 in W.G. 78-21 is amended to include another example where a significant distortion may exist, as follows:

ANSWER

c. Disproportionate Material and Subcontract Content.

The existence of a wide range of material and subcontract content among contracts may signal the precondition for potential significant distortion. For example, suppose that a contractor's material and subcontract content for most of a business units total activity normally ranges from 20 percent to 70 percent of total contract costs. This situation, in and of itself, does not prove that a significant distortion exists. Such a distortion may exist if the material and subcontract content of most contracts falls at the range's extremes. However, no significant distortion would likely exist if the material and subcontract content of most contracts fell within a relatively narrow band within the range (e.g., 30 percent to 50 percent). It should be noted that the percentages used in this example are for illustrative purposes only and are not intended to be uniform guidelines. Whenever there is an indication that a significant distortion exists, further consideration of the circumstances is necessary to arrive at a conclusion. Disproportionate cost ratios may merely represent variations in activity. For example, analysis of the activity on the contracts with extremely high material cost content may disclose that the costs represent subcontracts which are designated procurements and drop-shipped to the customers. Such circumstances would support a determination that the costs do not fairly represent the activity performing the contract. On the other hand, the analysis may disclose that the costs represent subcontracts for work that is subject to make-or-buy decisions and in fact is being performed in-house on other contracts. Such circumstances would support a determination that the material costs are representative of the activity of performing the contract. Consideration of the particular circumstances is essential before making a determination.

CAS STEERING COMMITTEE INTERIM GUIDANCE
W.C. 78-21
16 January 1978

SUBJECT: Implementation of CAS 410, Allocation of Business Unit General and Administrative Expenses to Final Cost Objectives

References: a. W.C. 77-11
b. DAR 15-201.4

BACKGROUND

W.C. 77-11 provides guidance on implementation matters identified at the time CAS 410 was promulgated. Additional questions have surfaced during the development of contractor implementation proposals. This paper addresses those questions.

DISCUSSION

Since a variety of issues and related guidance are involved, the guidance will be presented in a question and answer format.

1. Question

Is it appropriate to include functional costs, such as program management, procurement, etc., in the G&A pool if all costs of a particular function are included?

Answer

No, unless the costs are insignificant. As defined in CAS 410 and emphasized in W.C. 77-11, G&A expenses are incurred for the general management and administration of a business unit as a whole. They must be allocated to final cost objectives on a base that measures the total activity of the business unit. G&A expenses are intended to have no direct causal or beneficial relationship with any intermediate or final cost objective. Applying the G&A definition requires appropriate purification of the G&A expense pool. 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.

2. Question

Prefatory remarks in the standard say, "Contractors who have included selling costs in a cost pool separate and apart from the G&A

expense pool may continue that practice or may change and include selling costs in their G&A expense pool." May selling costs be included in the G&A expense pool if an inequitable distribution results?

Answer

No. Although the prefatory remarks are permissive in this regard, the standard's fundamental requirement paragraph 410.40(d)(1) requires a separate allocation of costs which can be allocated to business unit cost objectives on a beneficial or causal relationship which is best measured by a base other than a cost input base. Further requirements in paragraph 410.50(b)(1) indicate that the allocation base for combined pools must be appropriate for both. ASPR tests of allocability and reasonableness must also be satisfied. Therefore, if a significant disparity exists in marketing activity for elements of the business, selling expenses should be the subject of a separate distribution in reasonable proportion to the benefits received. For example, it may be appropriate to separately allocate selling costs of foreign and domestic markets.

3. Question

The standard says, "The cost input base selected to represent the total activity of a business unit during a cost accounting period may be: (1) total cost input, (2) value-added cost input, or (3) single element cost input." Is the total cost input base preferred?

Answer

Yes. The standard says, "A total cost input base is generally acceptable as an appropriate measure of the total activity of a business unit." The prefatory comments say, ". . . the term 'total activity' refers to the production of goods and services during the cost accounting period." Thus, unless circumstances exist where a significant difference is apparent between the activity involved in the production of goods and services during the cost accounting period and the costs of such activity a total cost input base should be used. When circumstances exist where total cost input does not appear to be an appropriate measure of total activity of the business unit, other bases available in the standard should be considered. However, the conditions involved should be carefully considered before departing from a total cost input base. The value-added base shall be used where inclusion of material and subcontract costs would significantly distort the allocation and where costs other than direct labor are significant measures of total activity. What constitutes a significant distortion in this context will be addressed as a separate question below. The criteria for use of a single element cost input base are very specific. The standard says, "A single element base may not produce equitable results where other measures of activity are also significant in relation to total activity.

A single element base is inappropriate when it is an insignificant part of the total cost of some of the final cost objectives." Considering the criteria for the use of the value-added and single-element bases, the thrust of the standard is toward implementing a total cost input base in most situations. Purification of the G&A expense pool is the most viable approach to minimizing any potential inequities which may surface in implementing the total cost input base.

4. Question

Should interdivisional transfers be included in a total cost input base?

Answer

Yes. The inclusion of interdivisional transfers in a total cost input base is supported by several provisions of the standard. CAS 410.40(b)(1) states that business unit G&A expenses shall be allocated ". . . by means of a cost input base representing the total activity of the business unit. . . ." CAS 410.50(d) supplements that fundamental requirement by stipulating that the cost input base used to allocate G&A costs include "all significant elements of that cost input which represents the total activity of the business unit." Prefatory comment no. 1 also lends support by stating that ". . . when a total cost input base has been selected, all significant costs other than the costs included in the G&A expense pool should be included in the base."

Given this interpretation of CAS 410, there are only two ways in which interdivisional transfers may be excluded from the receiving division's G&A base. These are (1) the use of a base in appropriate circumstances whose constituent parts do not include material, such as value-added or single-element base, or (2) when the interdivisional receipts are not significant.

Disputes as to the inclusion of costs such as interdivisional material or the selection of a base often obscure a more fundamental aspect of compliance with CAS 410. This is the requirement that the G&A pool represent only the centralized management costs as discussed in question no. 1 of this guidance paper. Correct "purification" of many existing G&A pools will greatly minimize the impact of base selections.

5. Question

What type of circumstance would meet the value-added base criteria that inclusion of material and subcontract costs would significantly distort the allocation of the G&A expense pool in relation to the benefits received?

Answer

Responding to this question requires consideration of the context in which the criteria is presented in the standard and of related comments published by the CAS Board.

In describing the G&A base in 410.50(d), the CAS Board said, "The cost input base used to allocate the G&A expense pool shall include all significant elements of that cost input which represent the total activity of the business unit." In the prefatory comments the CAS Board said, ". . . 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 which bears a reasonable relationship with the production of goods and services. The criteria for a value-added base appears to be referring to a significant distortion in that relationship.

The production of goods and services requires material, labor, overhead, and other direct and indirect elements in varying amounts. The fact that a variance in amounts occurs usually reflects a variance in activity involved rather than a distortion in the relationship of costs and activity. However, when the activity involved in cost objectives is similar but the costs vary significantly, this usually indicates that a distortion exists for which use of a value-added base should be considered.

Two examples of circumstances in which significant distortions would likely lead to a decision to use a value-added base are described below:

a. Government-furnished components. The Government may furnish engines in its contract for aircraft. Similar aircraft are sold to commercial customers, but the contractor issues subcontracts for the engines, including engine costs as part of the price. The same general management and administration of the business unit as a whole exists whether the customer furnishes the components or not. Consequently, including the component costs would significantly distort the results of using a total cost input base. Assuming no other circumstances of the contractor's activity would mitigate satisfaction of the standard's criteria for use of a value-added base, exclusion of material and subcontract costs would probably eliminate the distortion (the standard does not permit exclusion of engine costs only).

b. Precious metals. Products with similar configuration may have as the only difference the fabrication of one in gold and the other in sheet metal. The result would be that one product would have such a substantially greater material cost level that total cost input would not be representative of the activity of the business unit. However, this type of circumstance should be reviewed with special care. Additional general management and administration costs may be necessary

because of the greater cost level. For example, more financial accounting may be required to determine cash flow requirements and to support financing arrangements. Top-level management may be expected to monitor high-cost areas more than other elements of the business.

Once a distortion has been identified, the CAS Board's published materiality criteria may be helpful in determining whether the distortion is significant.

Equally important to assessing whether a significant distortion exists is considering whether use of a value-added base would minimize the distortion and result in an allocation best representing the total activity of the business unit during a cost accounting period. If not, its use would not comply with the basic requirement of the standard.

6. Question

The standard states, "A value-added cost input base is total cost less material and subcontract costs." Should indirect material and subcontract costs be deducted from total costs to arrive at the value-added base? What is the definition of subcontract costs?

Answer

The costs deducted from total costs to determine the value-added base should be limited to direct material and subcontract costs. The DD Form 633 under the heading of direct material provides an authoritative definition of subcontract costs which states, "Include parts, components, assemblies, and services to be produced or performed by other than you [the contractor] in accordance with your designs, specifications or directions and applicable only to the prime contract."

In applying this definition care must be taken to avoid inappropriate inclusions or exclusions from the value-added base as a result of a broad application of terminology or individual contractor account classifications. For example, subcontract labor of the "body shop" type is often used to supplement the normal work force and is used interchangeably with the regular employees under the direction of the same supervision. Under these circumstances, the work performed 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.

7. Question

When may a single element cost input base be used to allocate the G&A expense pool?

Answer

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 in relation to total activity. The contractor should periodically analyze the single element base to assure that it continues to best represent 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.

8. Question

CAS 410.50(j) prescribes use of a special allocation of G&A expenses where a particular final cost objective in relation to other final cost objectives receives significantly more or less benefit from G&A expense than would be reflected by allocation on an otherwise acceptable cost input base. What guidelines should be followed in applying this provision?

Answer

The CAS 410.50(j) provision is applicable only to a particular final cost objective which is an exception to the contractor's normal operation. An illustration of a circumstance appropriate for using a special allocation is shown in CAS 410.60(g). A contractor who normally constructs base operating facilities receives a significantly unusual requirement in one contract to acquire operating equipment for the base being constructed. A particularly important comment there says agreement by the parties is necessary. Taking this in conjunction with the standard's prefatory comment that the special allocation provision calls for the exercise of judgment, it appears that the intent is to use the special allocation provision in exceptional cases to resolve situations where equitable allocation to a particular cost objective cannot be achieved by normal methods.

Prefatory comments to the standard state:

If the G&A expense pool meets the requirements of the Standard, the existence of a need for special allocation to a class of contracts or type of situation would indicate that the allocation base being used is not representative of the total activity of the business unit during a typical cost accounting period.

Thus, before approving a special allocation the G&A expense pool should be carefully reviewed to purify it of any expenses which may be allocated to cost objectives more directly than by a cost input base. If a significant distortion still exists, then the cost input base selected should be reconsidered.

Administrative Contracting Officer should exercise caution in agreeing to the use of a special allocation. The use of a special allocation to gain a competitive advantage is not appropriate. However, it is recognized that the same operation may be normal in one contractor's circumstance but represent a special allocation situation in another contractor's circumstance.

9. Question

When a special allocation under CAS 410.50(j) is used, must it be described in the contractor's Disclosure Statement?

Answer

Yes. The contractor must amend his Disclosure Statement. Otherwise the contractor would be in noncompliance for failure to follow disclosed practices. The description should identify not only the special allocation but also the circumstances which required its use.

10. Question

CAS 410.50(g)(2) provides that separate allocations of significant home office centralized service functions, staff management of specific activities of segments, and central payments or accruals shall be allocated to segment cost objectives in proportion to the beneficial or causal relationship between the cost objectives and the expense where such a relationship is identifiable. When separate allocations are reflected in home office cost accounting, must the separate allocations be identified as such in the cost transfers to the segments?

Answer

Yes. The requirement for this is CAS 403. To support that home office expenses charged to a CAS-covered contract were allocated to the segment in compliance with CAS 403, the contractor should be required to identify the allocation base and components of the expense pool.

11. Question

Should a facilities contract as defined in DAR 7-701 be included in the total cost input base?

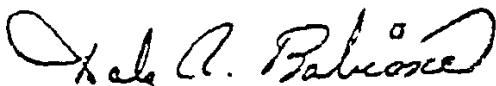
Answer

Yes, unless the provisions of CAS 410.50(j) apply. See Question 8.

DAR 7-701 states that facilities contracts can take the following forms:

- a. Facilities Acquisition Contract which provides for acquisition, construction, and installation of facilities.
- b. Facilities Use Contract which provides for maintenance, accountability, and disposition of facilities.
- c. Consolidated Facilities Contracts which provide for both a and b above.

With respect to Consolidated Facilities Contracts, there may be cases where it would be appropriate to apply the provisions of CAS 410.50(j) to only one portion of the contract and not the other, e.g. only to the facilities acquisition portion of the contract and not to the facilities use portion.



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SUBJECT: CAS 409 and the Development of Asset Service Lives

Background

1. CAS 409 applies only to assets acquired by a contractor after the beginning of its next fiscal year after receipt of a CAS-covered contract after 1 July 1975. For most contractors, CAS 409 became applicable to their tangible capital assets acquired after 1 Jan 76. CAS 409.50(e)(3) grants the contractor a 2-year period following the date when the standard must be followed for the development of adequate historical records to support the asset lives used in computing depreciation for those assets to which the standard is applicable.

2. In describing criteria for estimating service lives initially established for tangible capital assets (or groups of assets), CAS 409.50(e) says, in part: "The estimate of the expected actual periods of usefulness need not include the additional period tangible capital assets are retained for standby or incidental use where adequate records are maintained which reflect the withdrawal from active use." In addition, CAS 409.50(e)(2) provides in part: "Supporting records shall be maintained which are adequate to show the age at retirement or, if the contractor so chooses, at withdrawal from active use (and retention for standby or incidental use) for a sample of assets for each significant category."

Discussion

1. Equitable adjustments of CAS-covered contracts for accounting changes required by CAS are generally applicable only to those contracts in existence on the effective date of the standard (see W.G. 76-7). An exception to that general rule is seen in the provisions of CAS 409 which allow a grace period to develop records of asset service lives. During this period, many contractors have used some other method than their historical records to estimate asset service lives. Under these circumstances, asset service lives for those assets acquired during the grace period are not required to be adjusted to this historical lives. Therefore, the first applicability of the requirements to base asset service lives on historical records of experience takes place after the grace period. Consequently, all CAS-covered contracts and sub-contracts awarded before the conclusion of the grace period are subject to equitable price adjustment for changes related to adopting the new method of arriving at asset service lives for assets acquired after the grace period.

2. There is another issue raising questions about asset service lives. The CAS 409 provision for adjusting service lives to reflect standby or incidental usage provides the contractor an opportunity to prevent having longer lives applied in the depreciation process merely because an asset is not disposed of when withdrawn from active use. To take advantage of this opportunity, the contractor must maintain a record supporting the status of assets.

"Standby" status exists when the asset is withdrawn from regular usage with no definite plans for continuing its use. The asset is retained merely for possible temporary replacement during repair of a productive asset, emergency, or other unusual usage. Diminishing the usage to a part-time basis does not constitute "standby" status.

Guidance

1. Equitable adjustment procedures are available to the initial compliance with the historical records requirement of CAS 409.50(e)(3) for all CAS covered contracts existing prior to the end of the grace period.

2. Contractors should be required to provide sufficient detail in records of asset lives or other documentation to support that assets retained for standby or incidental use were withdrawn from service. As indicated in CAS 409.50(e)(2), the records may be for a sample of assets for each significant category. These records are required only when asset lives are adjusted for standby or incidental use.

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SUBJECT: Administration of Equitable Adjustments for Accounting Changes not Required by New Cost Accounting Standards

Background

The original Cost Accounting Standards (CAS) clause required the contracting parties to negotiate an equitable adjustment to contract prices whenever the application of a new standard resulted in a change in an accounting practice and an associated change in contract cost. Changes in accounting practices other than those required by new standards could only be made as long as there was no increased cost to the Government.

Effective 10 March 1978, the CAS Board added a new subparagraph to the CAS clause (331.50(a)(4)(C)). This new subparagraph permits the use of equitable adjustment procedures in connection with the cost impact of any accounting change which the contracting officer determines to be desirable and not detrimental to the interest of the Government.

A number of questions have arisen concerning the proper use of this new contract provision. This paper addresses those questions.

Questions and Guidance

1. What criteria should be used in determining whether an accounting change is desirable and not detrimental to the interest of the Government?

The term "desirable" encompasses the tests of being appropriate, warranted, equitable, fair or reasonable. The contracting officer's finding shall not be made solely because of the financial impact of the proposed change on the contractor's current CAS-covered contracts. A change may be desirable and not detrimental to the interest of the Government even though costs increase.

2. May existing contracts which do not contain the new subparagraph be modified to include the provision?

Yes. Circumstances could arise where the contracting officer, for administrative convenience or other legitimate reason, would want to insert the new subparagraph into contracts which do not contain the provision. In such cases, it is permissible to modify existing CAS-covered contracts if both contracting parties agree to the change and if adequate consideration is given.

3. Who has the authority to execute such modification?

The PCO has the authority to negotiate the modification. Therefore, whenever an ACO believes a modification is necessary, the PCO should be requested to initiate the change.

4. Must the price or cost of each contract affected by the cost impact of an accounting change be adjusted when the provision of the new subparagraph is used?

No. The current regulations, which permit the ACO to net increases under some contracts against decreases under other contracts thus reducing the number of individual contract price adjustments, are applicable to the new provision.

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and Systems Acquisition)

SUBJECT: Allocation of Business Unit General and Administrative (G&A)
Expense to Facilities Contracts

Background

Questions have been raised regarding the propriety of including costs of facilities acquisition in contractors' G&A expense allocation bases.

Cost Accounting Standard (CAS) 410 provides that the cost input base used to allocate the G&A expense pool shall include all significant elements of that cost input which represents the total activity of the business unit. Specific criteria are provided for three bases for allocating G&A expense: (1) total cost input, (2) value-added cost input, and (3) single element cost input. The standard also permits a special allocation of G&A expense to a particular final cost objective, if that objective receives significantly more or less benefit from G&A expense than would be reflected by the allocation of such expense using the contractor's normal allocation base. The special allocation provides a means for accounting for aberrations of normal business activity that could involve more than one final cost objective.

Discussion

Contractors' normal operations consist of the production of goods and services, such as aircraft or weapons systems. Contractors may, however, also receive Government facilities contracts which require the acquisition of significant amounts of facilities. These purchases are made at the direction of the Government, and no profit is granted to the contractor for making the acquisitions.

Facilities acquisition contracts normally do not require the same level of contractor risk and associated management attention as contracts which provide for the delivery of regular goods and services. As a result, a full allocation of a contractor's management or G&A expense to such contracts would generally not be equitable. An exception to this would be the rare circumstance when the preponderance of the contractor's activity is acquiring facilities as a service for the Government.

Government-funded facilities, when needed by a contractor to meet production contract requirements, are usually provided under a single facilities contract. However, in some instances contractors are awarded two or more concurrent contracts for the acquisition of facilities. The dollar magnitude of facilities acquisition under these contracts may be substantial when compared with contractors' normal business activities. However, because these acquisitions are generally not part of the normal business activity, this dollar magnitude is probably not a valid indicator of the proportion of G&A expense related to the facilities contracts.

In the case of consolidated facilities contracts (i.e., those contracts which provide for both facilities acquisition and facilities maintenance) a special allocation of G&A expense would be applied to the acquisition portion of the contracts. The maintenance portion would remain in the base and would receive the normal allocation of G&A expense.

Guidance

When a contractor has one or more facilities contracts, such contracts should be reviewed to ascertain whether they receive significantly less benefit from G&A expense than other contracts. This is usually the case.

When it is determined that facilities acquisition contracts will not receive an appropriate allocation of G&A expense by participating in the contractor's selected G&A expense allocation base, a special G&A expense allocation under the provisions of CAS 410.50(j) shall be required.

CAS STEERING COMMITTEE INTERIM GUIDANCE
W.G. 81-25
10 February 1981

SUBJECT: 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

BACKGROUND

State tax regulations usually permit a taxpayer to initially select one of several acceptable methods of stating the elements that determine taxable income and later, under specified conditions, to change from the initial selection to another acceptable method. Some elements for which alternate acceptable methods are allowed are (1) income from long-term contracts, (2) inventory pricing, and (3) depreciation methods.

According to CAS Board regulation 331.20(h), a "cost accounting practice" is any accounting method or technique which is used for measurement of costs, assignment of costs to cost accounting periods, or allocation of cost to cost objectives. According to § 331.20(i), a "change to either a disclosed cost accounting practice or an established cost accounting practice" is any alteration in a cost accounting practice, as defined in paragraph (h).

A number of major defense contractors recently changed their method of reporting income from long-term contracts for State tax purposes from a percent of completion method (PCM) to a completed contract method (CCM). Under PCM, the net income or loss for a contract is reported for each tax year by relating cost incurred to estimated revenue based on the percentage a contract is determined to be complete. Under CCM, the total net income or loss for a contract is reported in the year of completion.

Contractors typically have changed when CCM will eliminate or reduce their tax cost in the year of the change and the years shortly thereafter. When this occurs, the amount of state tax cost allocated to contracts will generally be lower than the amount projected to be allocated to the contracts at the time they were negotiated.

DISCUSSION

In order to establish that a change in cost accounting practice for State tax costs has occurred, it is necessary to identify the nature of the practice prior to the presumed change. The best evidence of the prior practice is the State tax cost previously estimated and recorded for defense contract purposes. In most cases, the practice prior to the change was to estimate and record based on the actual tax payment, or the amount for which a current liability exists. This is the position DAR 15-205.41 requires in terms of cost allowability; however, the same principles apply in terms of CAS allowability. Consequently, when a contractor changes the method of determining its actual tax liability, such as by changing from PCM to CCM of reporting contract income, it changes its cost accounting practice for State tax costs. The fact that a contractor does not change its financial accounting practice