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Subcontractor Incurred Cost Proposal Requirements

Subcontractors with reimbursable subcontracts are generally under the same Allowable Cost and Payment clause (FAR 52.216-7) requirement that prime contractors are since this clause is usually a flow-down requirement. Most reimbursable subcontracts contain this clause by reference, or words to that effect. This means a subcontractor would ordinarily be required to prepare provisional and final indirect rate submissions and annual incurred cost proposals just like a prime contract.

If a company is strictly a subcontractor (with reimbursable contracts), the question arises as to what incurred cost proposal information should be submitted to the government. DCAA audit guidance states that the prime contractor has the responsibility to ensure that the government is aware of all awarded reimbursable subcontracts, and to provide cost information regarding annual subcontract costs to the government/DCAA. Further, the prime contractor is responsible for either auditing the incurred costs billed by their subcontractors, or to otherwise notify DCAA of the need to audit those costs during the annual incurred cost audit at the prime level. In most cases, the prime contractor is not permitted by its subcontractors to examine its cost records in performing the traditional incurred cost audit; thus, DCAA is usually requested, or may self-

initiate, a cost audit of the subcontractors. Further, if subcontractor incurred costs are disallowed, the government's right of recovery of those costs is only with the prime contractor.

Some companies, *who are nothing more than subcontractors to primes*, with significant reimbursable costs, are under the impression that they need not formally prepare or submit an annual incurred cost proposal, with final indirect rates, to either the prime contractor or to the government. This philosophy persists since subcontractors have only a contractual obligation to provide annual incurred cost information only if their prime contractors require, or if DCAA specifically requests, those submissions.



The questions that arise from this dilemma are:

1. Are companies who are solely subcontractors to government prime contractors relieved of the responsibility of routine annual submission of incurred cost submissions in the same manner as primes?
2. Does DCAA initiate incurred cost audits of such companies only if requested by prime contractors, or should they be automatically performing those audits just as DCAA would for prime contractors?

3. Are such subcontractors required to certify its indirect costs, if they submit annual incurred cost proposals?

Preliminary answers to these questions are:

1. The conservative answer to this question is that the subcontractor should nevertheless abide by all provisions of the Allowable Cost and Payment clause, whether the company is solely a subcontractor or not. There is a case to be made that companies who have only reimbursable subcontracts would not, by regulation, be bound in preparing those submissions automatically upon fiscal year end, unless either the prime contractor or a Government agency sees a compelling reason for obtaining those formal proposals. Since this is a "gray" area, officials for such companies may want to discuss the ramifications of preparing, or not preparing, these submissions with their prime contractors.
2. In these cases, DCAA should work through the prime contractor to obtain the necessary subcontractor incurred cost proposal/final indirect rate submission. In other words, the first line of responsibility for obtaining subcontract incurred cost proposals or similar data and conducting audits of subcontract reimbursable costs is that of the prime contractor. However, should this not be possible, DCAA should ask for and work with the subcontractor directly in evaluating incurred cost.
3. Subcontractors are not required to certify indirect costs related to subcontracts. The certification requirement applies only to prime contracts. The penalties assessments imposed by FAR do not flow down to subcontracts.

Criteria for Evaluating CAS 418

The purpose of CAS 418 is to provide guidance regarding the consistency in determining direct and indirect cost, the criteria for accumulating direct and indirect cost, and the selection of allocation measures based on the beneficial or causal relationship between and indirect cost pool and final cost objectives. Key factors of evaluating the above criteria are 1.) homogeneity and 2.) materiality.

It appears that Contractors and DCAA sometimes forget that the materiality factor is an important piece of the evaluation of CAS 418. In fact, this is such a frequent occurrence that the courts recently reversed its own decision on a CAS 418 violation based on the materiality factor alone, (AM General LLC, ASBCA, No. 53610, 2/2/07). The courts originally ruled that AM General was in violation of CAS 418 because they were unable to show a homogeneous relationship in its manufacturing overhead pool because the government and commercial products had final assembly in different buildings. It was only after AM General hired new counsel that the subject of materiality arose, which led to the reversal of the previous ruling.



Therefore, in evaluating existing cost pools or the need for additional cost pools, bear in mind that the material effect of generating/changing a cost pool is as equally important as establishing the homogeneous relationship between the indirect cost and the final cost objective.

Are You Paying Your Vendors and Subcontractors in a Timely Manner?

Recently, the question has been asked, "What are a Contractor's requirements to pay vendors and subcontractors?" and "What are the consequences of late payment to vendors and subcontractors?"

You're probably thinking, just pay invoices as they come due. However, there are many legitimate reasons that companies push back the payment of vendor and subcontract invoices until the absolute last minute, especially if there are no penalties for late payment from the vendor or subcontractor. One reason is so the Contractor can increase float, which acts as a short term interest free loan maximizing the Contractor's earning potential. A second reason is because the Contractor is waiting on Customer payments (cash receipts) to avoid drawing on a line of credit or other financing source, thus saving on interest which is an unallowable expense. Whatever the reason may be, it is important to know the government expectations in terms of Contractor's paying their vendors and subcontractors.

For cost reimbursable contracts, FAR 52.216-7 dictates that the only costs, reimbursable by the government, are those costs which meet the following criteria:

- Recorded cost that has been paid by cash, check or other form of payment.
- Cost incurred for the acquisition of supplies and services but has not necessarily been paid, provided that payment will be made within 1) the terms and conditions of the subcontract, or 2) thirty days of the submission of the Contractor's payment request to the Government.
- Materials issued from inventory and placed in production for a contract.
- Direct labor, direct travel, other direct cost and the proper allocation of associated allowable indirect cost, and
- Subcontractor financing payments made by cash, check or other form of payment.

Therefore, if a cost does not meet these criteria, then that cost is not eligible for reimbursement by the government under cost type contracts.

Also, contractors, be aware that a subcontractor or supplier, when not paid timely, may make this assertion to the contracting officer. At this time, the contracting officer may investigate and can go as far as reducing or suspending payments, or if a certification of those costs exists, initiate administrative or other remedial action against the contractor.

Government Contract Training

Government Contract Accounting Systems Compliance

Brief Synopsis: This course is designed to detail the components of a government contract accounting system and explain how an accounting system helps to ensure your compliance with government contracting rules and regulations.

Presented by: Federal Publications Seminars

Dates: May 2-3, 2007, Washington D.C.

June 20-21, 2007, Las Vegas, NV

Instructors: Darryl Walker and Charlie Broome
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Future Newsletters

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