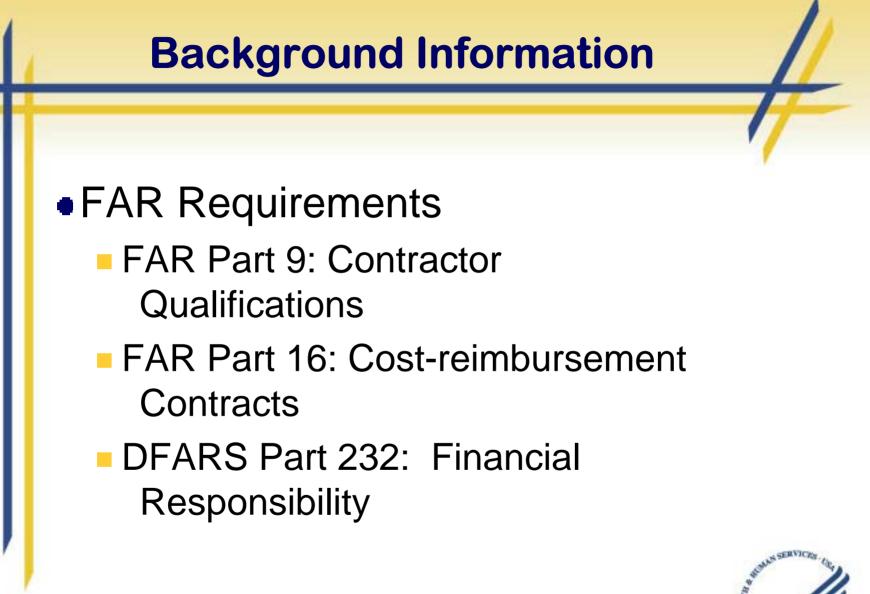
# Accounting Systems: Complying with FAR Requirements



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## **FAR Requirements**

Requires organizations have:
Financial resources to perform
Integrity and business ethics
Technical ability to perform
Accounting system to accumulate the costs on the contract





#### **Preaward Surveys**

#### Accounting System

 Review of various accounting data to determine if system is adequate for accumulating and reporting costs on a contract (SF 1408)

#### • Financial Capability

Review of key financial data, balance sheet, income statement, and cash flows to ensure that the contractor has the financial resources to complete the contract (SF 1407) (FAR 16.301-1)





# **Accounting System**

- Review to determine the acceptability of the system for accumulating costs under a Government contract
- Review the design and operation of the system to reach an informed opinion on whether the system is acceptable for Government contracts





# **Accounting System**

- Contractor's Control Environment
  - Sets the tone of an organization
  - Foundation for all other components of internal control – providing discipline and structure
- Contractor's Overall Accounting Controls
  - Financial controls concerned with ensuring reliable financial data and statements
  - Compliance controls concerned with ensuring compliance with applicable laws and regulations





# **Control Environment**

#### Integrity and Ethical Values

- Written code of conduct addressing ethical business practices, conflicts of interest, and standards of ethical behavior
- System of identifying noncompliances with codes of conduct and corrective actions
- Self-governance programs





# **Control Environment**

#### Board of Directors/Audit Committee

- Independent and actively involved in significant decisions
- Audit committee is effective in reviewing internal and external audit recommendations





# **Control Environment**

 Organization Structure and Assignment of Authority and Responsibility

- Assignment of responsibility and delegation should provide a basis of accountability and control
- Ensure a segregation of duties critical to the internal controls



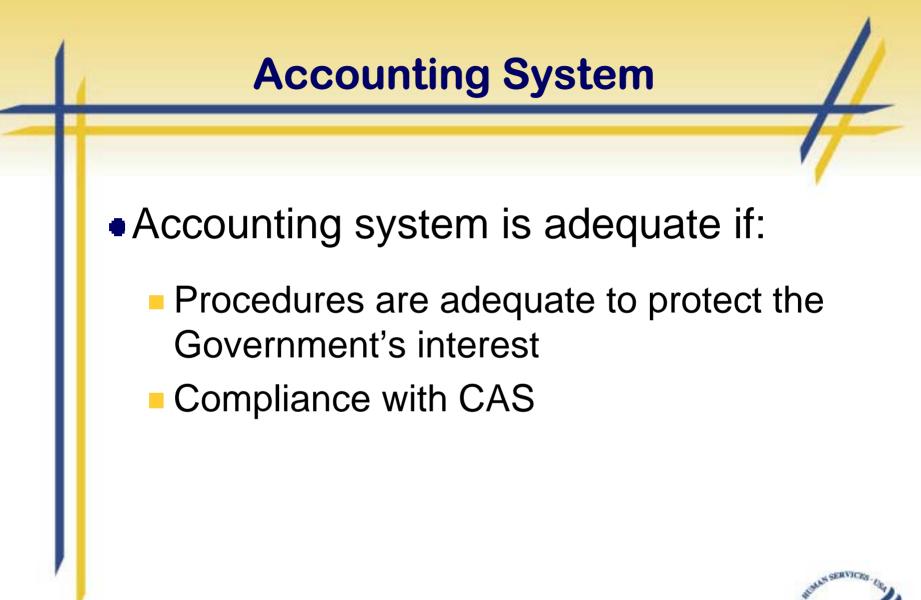


# **Accounting System**

- Consist of methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions
- Maintain accountability for related assets and liabilities
- Well designed to provide reliable accounting data and prevent misstatements that would otherwise occur











# **Accounting System**

#### GAAP

- Proper segregation of costs
- Direct costs by contract
- Allocation of indirect costs
- Costs under general ledger control
- Timekeeping system
- Labor distribution

- Exclusion of unallowable costs
- Interim determination of costs
- Costs by contract line item
- Limitation of costs
- Billings
- Adequate & reliable







 Accumulation of all accounting data is based on generally accepted accounting principles

 Supportable by internal and external auditing processes





# **Proper Segregation of Costs**

- Establishment of a Chart of Accounts defining direct and indirect functions
- Controls in place to preclude direct charging of indirect expenses
- Controls in place to preclude indirect charging of direct contract costs





# **Direct Costs by Contract**

- Establishment of a Chart of Accounts defining various contracts
- A subsidiary job cost ledger which accumulates costs by contract and is reconciled to the general ledger
- Controls in place to preclude mischarging of one contract effort with another contract





# **Allocation of Indirect Costs**

- Policies and procedures in place for the accumulating and billing of indirect expenses
- Accumulation in logical groupings and allocated based on benefits accrued to intermediate and final cost objectives
- Cost accounting system is formally documented with a written description of the contents of the bases and pools



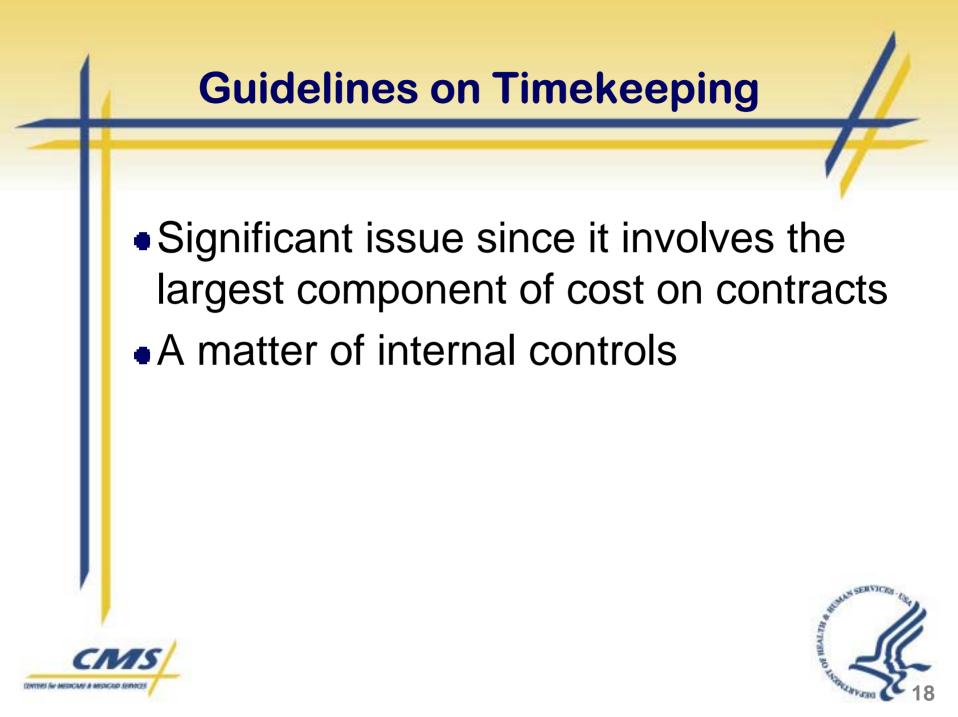


# Costs Under General Ledger Control

- Contractor's job cost ledger, labor distribution, and other books of account are reconcilable to the general ledger
- Posting to the books of account and the reconciliations are done on a current basis







#### **CMS Emphasis**

- Focus is on a system of internal controls
- What has the contractor established in both procedures and compliance to reduce the overall risk in the area of labor costs





# **Guidelines on Timekeeping**

 Policies and procedures governing the accumulation and billing of labor costs

- Procedures for timekeeping
- Procedures for processing payroll
- Procedures for labor corrections and transfers





# **Internal Controls Over Labor**

- Effective method to monitor overall integrity of the labor/timekeeping system
  - Conduct regular internal reviews that address: policies, consistent application of them, and follow-up on any deficiencies noted
  - Perform floorchecks, review of exception reports, etc.





- Effective employee awareness training program
  - Policies and procedures to ensure that all employees are aware of the importance of proper time charges
  - New hires training and refresher courses for existing employees
  - Awareness of penalties imposed by the government (i.e. False Claims Act)
  - Goes to the issue of top management creating an ethical environment





#### • Effective labor authorization/approvals

- Procedures to facilitate the accumulation and recording of labor costs to the proper cost objectives
- Segregation of duties between key personnel (i.e. Timekeeping vs. Payroll)
- Supervisors who are accountable for meeting budgets should not have the opportunity to initiate changes to employees time charges





#### Effective description of work

- Procedures to facilitate the clear identification of the nature of the work performed
- Enough detail to be trackable to the final cost objective
- Sufficient to determine the allocability of the charges to government contracts/grants





#### Effective timekeeping system

- Procedures to assure that the labor hours are accurately recorded
- Any changes are properly documented including authorizations





#### Manual timekeeping system

- Timesheets are preprinted with employee name and ID number
- Employees prepare their timesheets in ink, on a daily basis
- Supervisory observations of employee arrivals and departures





#### Manual timekeeping system

- Corrections are made in ink, initialed by employee, properly authorized and explanation for revision
- Employee and supervisor sign timesheet verifying the accuracy of the recorded labor





#### Electronic timekeeping system

- Employee badge issuance is controlled (no duplication, no unauthorized persons)
- Procedures in place requiring reporting of lost badges
- Revisions are documented via electronic passwords
- Same audit trail as in the manual system even though it is electronic





# **Labor Distribution**

#### Effective labor distribution

- Policies to require verification of the hours in the labor distribution summary agrees with the hours entered into the timekeeping and payroll systems
- Procedures that generate an audit trail documenting the distribution of direct and indirect labor charges to the proper cost objectives





## **Labor Distribution**

#### Other effective controls

- Review significant increases and decreases in sensitive labor accounts
- Procedures that ensure proper documentation of labor transfers or adjustments
- Procedures addressing overtime authorization





# **Interim Pricing**

- Contractor posts contract costs at least monthly to books of account
- Contractor utilizes provisional indirect rates and monitor the rates for any significant variance
- Contractor compares the actual expenditures to the contract amounts





# **Exclusion of Unallowables**

- Procedures in place to identify and exclude unallowable costs from any government billing in accordance with FAR 31
- Chart of accounts in place that supports the policies
- Employees trained in the area of what constitutes an unallowable cost





## **Costs by Contract Line Item**

 Contractor has procedures in place to determine the appropriate level of reporting cost information that corresponds to Government requirements

 Can the contractor's system be expanded to the requisite level of detail





# **Limitation of Costs**

- Total contract expenditures against contract limitations on price or cost are monitored and updated
- Controls exists to ensure compliance with reporting requirements of FAR 52.216-5,-6,-7,-16 and -17 or FAR 52.232-20, -21, -22





# **Billing/Reimbursements**

- Claimed costs can be traced to the job cost ledger
- Provisional rates utilized to bill the indirect expenses
- Standard Form 1034 properly completed





### **Contract Briefs**

Synopsis of all pertinent provisions

- Type, amount, service provided
- Types of indirect rates
- Any ceilings or billing limitations





### Adequate, Reliable Data

- Is the accounting system kept on a current basis; and
- Is cost information capable of producing information at sufficient level of detail for use in pricing follow-on contracts





 Assessment to determine if contractor is financially capable of performing on Government contracts

- Financial difficulties may
  - Disrupt schedules
  - Result in contract nonperformance





• Early assessment of contractor difficulty allows flexibility to the Government to:

- Avoid loss of critical services
- Protect Government property and inventory
- Develop alternative sources
- Assessment to determine if contractor is financially capable of performing on Government contracts





 Early assessment of contractor difficulty allows flexibility to the contractor:

- Borrowing of money
- Liquidating of assets
- Reducing capital expenditures
- Reducing workforce





#### Evaluating various financial data including:

- Three to five years of audited financial statements
- Analytical review utilizing key financial ratios
- Evaluation of cash flow projections
- Review of off-balance sheet items
- Review of related party transactions





# **Key Financial Ratios**

| Ratio                      | Formula  |
|----------------------------|--|
| Current Ratio              | Current Assets/Current Liabilities   |
| Acid Test (Quick Ratio)    | Liquid Assets/Current Liabilities  |
| Return on Investment (ROI) | Net Income/Total Assets  |
| Debt to Equity Ratio       | Total Debt/ Stockholders Equity  |
| Cash Flow to Debt          | Cash Flow (Net Income+ Depreciation + Depletion + Amortization)/Total Debt           |
| Cash Flow Return on Assets | Cash from Operations/Total Assets  |
| Cash Flow to Sales         | Cash from Operations/Sales   |
| Cash Flow Adequacy         | Cash from Operations/(Long-term Debt Paid + Purchases<br>of Assets + Dividends Paid) |
| Debt Coverage              | Total Debt/Cash from Operations  |





• Assessment will conclude with:

- Satisfactory comments relative to data
- Conditions of quarterly monitoring of future interim financial statements
- Denial of contract award





#### **Questions and Answers**



