



DIRECT AND INDIRECT COST AND IMPORTANT ACCOUNTING ISSUES FOR ENGINEERS

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Welcome

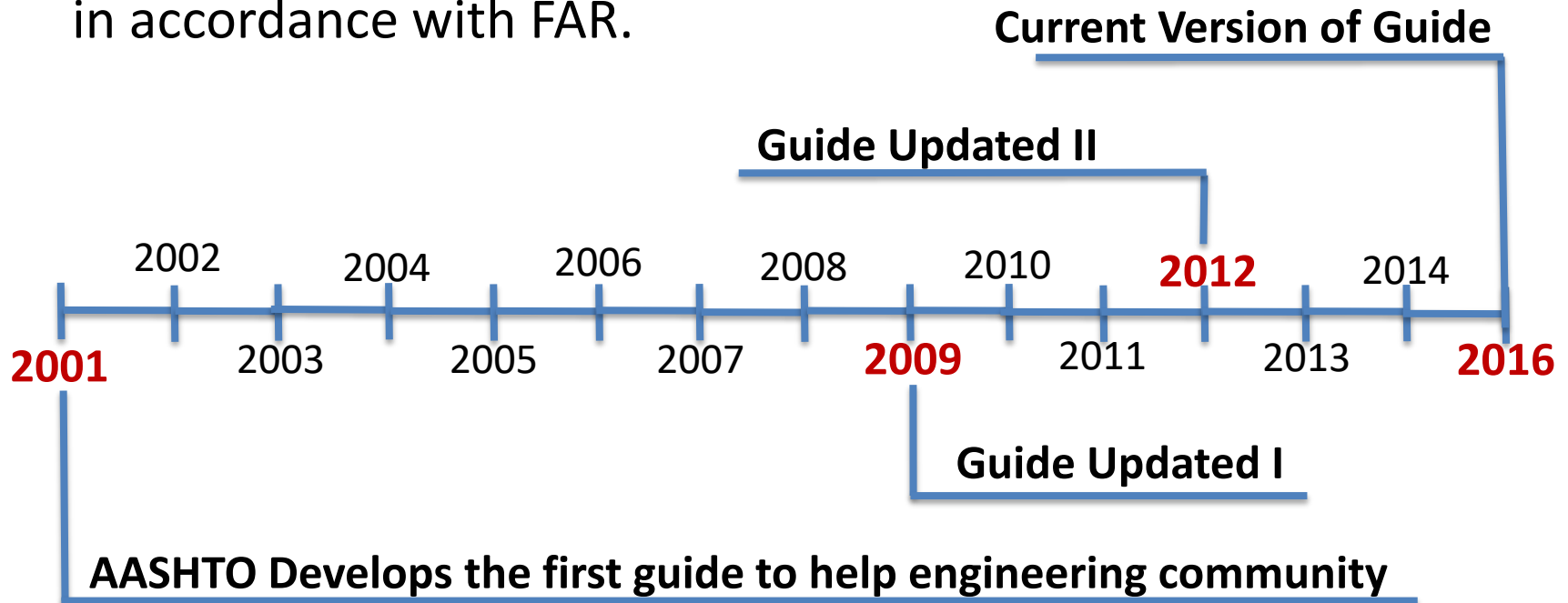
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Objectives of the Meeting

- Show the importance of developing an effective accounting system
- Discuss policies that will affect the firm's indirect rate: for example timekeeping policies; bonus policies; billing policies and raise policies.
- Show examples of how the policies will affect the indirect cost rate

Background on FAR & AASHTO

Over the years more and more engineering firms are discovering that they must have and audited overhead rate in accordance with FAR.



- The goal of the guide is to have some uniformity between the state DOT's, Firms and CPA's.
- The AASHTO guide is not authoritative document. Rather the FAR is the authoritative guide.

The Government Rule-Making Structure

Congress - makes laws related to government procurement

FAR Secretariat - the rulemaking body that develops (or updates) FAR taking into account laws and current business practices.

Cost Accounting Standards Board (CASB) - develops more detailed accounting requirements for specific costs, limited to large contractors.

Board of Contract Appeals (ASBCA) - the federal court established specifically for cases involving government contracts.

Defense Contract Audit Agency (DCAA) - now the cognizant agency for all civilian contractors, sets audit standards and accounting methods

Federal Law

- Federal law **MUST** be followed if Federal Funds are Used

State Law

- State law **MAY NOT** override federal law
- State law **MAY** override federal regulations or policies

Federal Regulations

- Federal regulations take precedent over state regulations

State Regulations

- Even if state/local funding is used to match federal funds, it is **STILL** a federal project.

Under FAR, the Government will Pay

1. “Fair and reasonable” cost of performing the work:
 - All costs legally required to be a business
 - All costs not specifically made unallowable by the FAR
 - All normal costs of conducting a business in a normal, prudent manner.

2. Plus a “reasonable profit”:
 - Between Federal Rules or between 6% and 15%

The FAR Compensation Formula =

$$\begin{aligned} & \text{Level of Effort (Hours)} \\ & \quad \times \\ & \text{Direct Labor Rates (\$/ Hr.)} \\ & \quad + \\ & \text{FAR Overhead (\% of D.L.)} \\ & \quad + \\ & \text{Expenses} \\ & \quad + \\ & \text{Profit} \end{aligned}$$

This method is used to allow firms to be reimbursed for:

- Actual and allowable expenses

Government processes are based upon:

- FAR compensation formula
- The A/E contracts are based on the Non-Competitive Bid Process which is established in the Brooks Act.



CDOT Process:

- Master Pricing Agreement

This is applicable to both
Prime and **Subconsultants**

Two Types of Annual Qualifications

- Technical Qualification
 - Required for Form 1058 to Contracts and Market Analysis

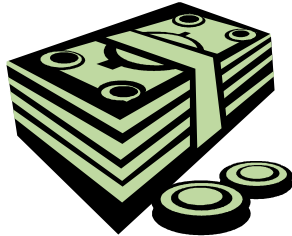
- Financial Qualification Process
 - Review of Accounting System
 - Review of Organizational Policies
 - Review that Billing is in accordance with 48 CFR part 31

*****ALL** firms are to have a **Master Pricing Agreement**

Who is required to have an Indirect Rate?

Based on the annual cash receipts from CDOT in the previous year and **YOUR** accounting system:

If:

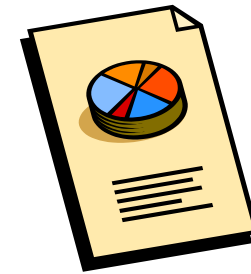


> \$500,000

Net Cash receipts from CDOT

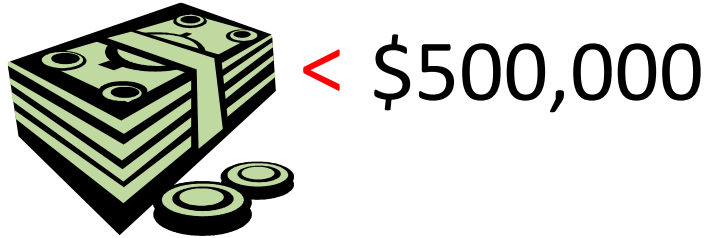
- Prime and subcontract less pass through

Then:



You **ARE** required to submit an **audited** indirect schedule

If:



< \$500,000

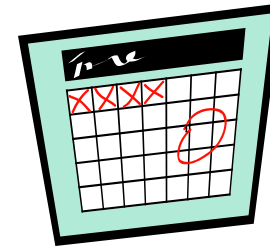
Net Cash receipts from
CDOT

- Prime and subcontract
less pass through

And:

You have an adequate
accounting system

Then:



You need to submit a
compilation of your
indirect rate schedule.

- This is **NOT** an **audited**
indirect schedule

If:  **But:**



Net Cash receipts from
CDOT

- Prime and subcontract
less pass through

The firm

- Does not have a fully developed
cost accounting system
- Has not had an indirect rate
accepted by cognizant agency
- Does not have a relevant
contract history to use as a base
for developing a FAR compliant
indirect rate

Then:

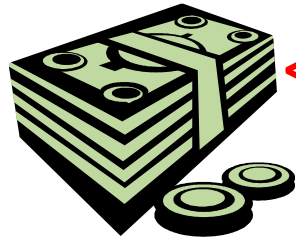
You **ARE** required to use Billing rates
used on other clients **Colorado does
not use the Safe Harbor Rate.**



If:



And:



< \$500,000

Net Cash receipts from CDOT

- Prime and subcontract less pass through

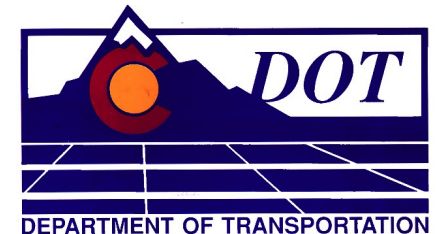
The firm

- Are sole proprietors
- Provide other specialized services
- Has not historically used an indirect rate in their accounting system.

Then:

You **Need** to contact CDOT Audit Division for guidance for documentation.

- Mostly, documentation is a fee schedule and supporting invoices



What is the criteria for an adequate accounting system???

- Accounting System That:
 - Segregates direct, indirect costs and unallowable costs
 - Can identify and accumulate direct costs by contract or task
 - Accumulates costs under General Ledger Accounts
 - Charges direct and indirect labor by contract or cost objective
 - Is periodically reconciled
 - Excludes unallowable costs from Contracts
 - AND has a time keeping process

Time Keeping / Labor Charging process

- Requires ALL employees to record ALL hours worked, paid and unpaid, even if over 40 hours.
- Accounts for uncompensated overtime even if over 40 hours.
- Ensures proper distribution of labor costs
- Reconciles labor accounts to the General Ledger.

Consultants Responsibility

1. Needs to Comply with GAAP (Generally Accepted Accounting Principles)
2. Maintains adequate accounting records
 - a. Job Cost system supporting General Ledger
 - b. Unallowable costs identified in general ledger
 - c. In compliance with Government regulation
3. Estimates and proposes a system to match accounting records
4. Selects a qualified auditor (Commercial Break Later)

Accounting System must allocate direct costs to the contracts and separate from the overhead pool.

System must contain a job cost accounting system

Accounting Requirements

1. All projects must have a project record where costs are posted and transferred to the general ledger account.

General ledger must contain classifications:

- Current Assets
- Fixed Assets
- Other Assets
- Current Liabilities
- Long Term Liabilities
- Equity
- Revenue
- Direct Costs
- Overhead Cost

Accounting Records Need:

1. To be maintained on the accrual basis of accounting
2. Accounting policies must be established and **CONSISTENTLY** applied.
3. Tax basis is not acceptable
4. Unallowable costs must be segregated
5. The accounting records are management responsibility

Consistency includes:

- Consistency in estimating, accumulating, and reporting costs. CAS 401
- Consistency in allocating costs incurred for the same purpose. CAS 402
- Accounting for unallowable costs. CAS 404
- Maintaining a consistent costs accounting period. CAS 406

Basis for Policy Decision

Business and accounting policies are established by the company.

The government or client do not dictate your policies.

Establish policies that are best for your firm

Types of policies are what is billable to clients.

Establish policies on how overtime is to be billed and what direct costs are to be billed.

Guidelines for Firm Policies

1. Firm policies should not be established based upon a single client.
2. The goal is to maximize revenue and profits.
3. What is good for one firm will not be best for another.
4. Overhead rates are a function of firm policies.
5. Your client mix will affect you policies and overhead.
6. Tax plan will have an affect on your policies and overhead.

The Golden Rule

Accumulate costs according to policy.

Bill according to Contracts Terms

What causes unallowable costs?

Use of inconsistent accounting policies.

DOT dictated policies.

Firm not consistent in application of policies.

“The client said they’ll pay for it”

Policies – Bid and Proposals

- When the Company is selected for a new project, the company should work to develop a scope and fee estimate using actual cost information or negotiated rates, as applicable, and historical experience on similar projects.
- Management review of the scope and fee estimate and are directly involved in the contract negotiation.
- A key objective in this process is to ensure that the treatment of costs in the cost proposal is consistent with the treatment of costs in company's job costing system and general ledger.
- For example, costs which are treated as overhead in the job costing system and general ledger must not be treated as direct costs in the cost proposal.

Policies – Billing

- **Billing Rate Development**
- The company should review standard billing rates on an annual basis.
- The review should included a comparison to market rates as well as actual employee costs and anticipated salary increases.
- The calculation of rates includes an analysis showing, when multiplied by estimated number of billable hour for the year, rates will cover all the firms expenses and achieve a predetermined reasonable profit.
- Remember – if the standard billing rate is lower than your government rate- You have to bill the lower of the two.

Time Sheet Policies

- Time Sheet are the basis of what you bill.
- You are trading time for dollars.
- Everyone must prepare a time sheet
- Total Hours must be reported
- Time sheet must be signed by employee
- (if manual, timesheet signature is to be in ink)
- Time sheet must be approved by supervisor.
- For owners – assign some one to be your reviewer of your time sheet
- Time sheets should be posted at least monthly to project and general ledger system

Time Sheet Policies

Time sheet should have the following categories included on them.

Overhead - Advertising/Public Relations - FAR Unallowable

Description: Labor hours incurred in activities related to advertising and general firm promotion such as staffing booths at trade shows, developing printed advertising materials, and working on firm promotional sections of the Company's website.

Overhead - Entertainment - FAR Unallowable

Description: Labor hours incurred in entertainment or recreation activities such as golf, attendance at sporting events, Company parties or picnics during working hours. Hours for these activities should be recorded here and are FAR-unallowable, even if they are incurred for a valid business purpose. Note, however, that certain employee recognition ceremonies may be allowable and should be examined on a case-by-case basis.

Overhead - Bid and Proposal - (FAR Allowable)

Description: Labor hours incurred in activities such as responding to requests for proposal (RFPs), developing technical and cost proposals and project scoping prior to contract execution.

Overhead - Direct Client Marketing - (FAR Allowable)

Description: Labor hours incurred in activities such as meeting with clients or prospective clients to discuss potential future work

Policies – Direct Labor

- Direct labor is to include all billable and non-billable amounts.
- It should be based upon employee's total direct labor hours x the employee's standard hourly rate.
- There should be a disclosure on how the premium portion of OT is reported. It depends on the policy.
- What are the different ways to treat it.

Policies – Salary Increase

1. Asking for salary increases are currently at renewal of MPA.
2. Anything new on this issue.
3. What if the employee should get a raise, but you can't bill the increase to the contract?

Policies – Bonus

- **Employee Bonus Program**
- In order to reward the performance of our team members, the company provides eligible employees with the opportunity to earn bonus compensation under the company's performance-based Employee Bonus Program.

- **Eligibility**
- All company employees are eligible to earn bonus compensation under this program. In determining bonus amounts, an employee's work status {e.g. full-time versus part-time, regular versus temporary) and length of service will be considered, but the primary basis for establishing bonuses is the performance of the individual employee during the period of review.

- **Period of Review**
- Bonuses are established and awarded for work performed during a calendar year and are not based on work performed in prior or future years.

Method and Timing of Bonus Compensation on Payment

It is the company's intent that employee bonuses are typically paid in the end of the year / first quarter of the new Fiscal Year, following the period of review; however, the company reserves the right to accrue all or a portion of awarded bonuses at year-end and pay such amounts immediately following the completion of annual employee performance evaluations. Bonuses to employees are paid in cash (check or direct deposit) .

Performance Measurement

In determining the amount of each employee's bonus, the employee's measurable performance is evaluated against one or more criteria as are applicable to the employee. These criteria include:

Utilization / billable percentage

- Net billable time (total less non-billable time) in excess of target utilization percent
- Utilization of regional employees

Project performance

- Net revenue (gross less non-billable time) of projects managed by the employee / region
- Net income of projects managed by the employee / region

- Quality of work
- Successful management of respective department
- Customer service / client feedback
- Peer relations
- Staff development

Policies –Executive Compensation

The Consultant is responsible for performing an executive compensation analysis.

Two ways to do it

1. National Compensation Matrix or
2. Getting three surveys and developing the average survey amount to compare to the total compensation of the executives.

National compensation Matrix is at our website and <http://audit.transportation.org/Pages/default.aspx>

For 2021 the maximum compensation is \$ 550,000.

Policies – Project Direct

Follow your policy!!!

If a cost was proposed as a direct cost, it is a direct cost along with all similar transactions.

Example:

In the direct cost policy, mileage for corporate owned vehicles are to be in the indirect. A client says that you should bill them for mileage. You now have inconsistent policy and a credit to the indirect for all direct mileage x billing rate.

Policies – Unit Pricing

Watch your policies and adhere to them.

Policies – Depreciation

Do not use tax depreciation.

- Tax depreciation has section 179 Depreciation in it and bonus depreciation.
- Accelerated depreciation (section 179) is unallowable. Thus, depreciation is going to be reduced.

Have a policy that states “for FAR purposes, GAAP depreciation is going to be used.”

- GAAP is straight line or double declining balance

Watch out for new
capitalization Policies
IRS issued new policies is 2018.

Do a proper year end cut off. Costs that are prepayments, should be recorded as a prepayment. Only include one year of expenses not 13 periods. Example is rent and insurance.

Policies – Field Indirect

What is a field indirect?

- The company determines if they want a field indirect
- CDOT may ask for a field rate on a project.
- Be careful in this area, You could lose big if you don't renegotiate the home office rate.

What Policies Should You Have

- Description of Accounting Practices
- Description of how the Rate is Prepared
- Description of Time Keeping is Tracked
 - How is direct labor documented
 - How is paid time off – given and tracked
 - How is overtime tracked and paid / billed
- How is officer compensation evaluated
- Bonus policy
- Depreciation Policy
- Direct project cost and how they are accounted for / billed

*** does not include all

Policies – Compliance with CAS

No contract is over \$50,000,000. Thus, the contracts are not CAS covered.

However, still have to comply with :

CAS 401

CAS 402

CAS 404

CAS 406

Policies – Cost Certification Policy

Effective for 2011

Contractor must certify cost submissions for overhead rates annually and with proposals

Contractor who knowingly charges unallowable costs to overhead could face:

- ✓ Suspension
- ✓ Debarment
- ✓ False Claim Act
- ✓ Imprisoned not more than 5 years

Truth in Negotiations

1. Only applies to federal contracts
2. The government contract dollar is part of the public records of government, thus you must disclose all information required. (Be sure it is required before handing it over).
3. You must disclose all current cost data in contracting.
4. Failure to disclose, or submitting false information is a criminal offense.

The False Claim Act

1. Knowingly presents a false or fraudulent claim for payment
2. Imposes liability on any person who submits a claim to the federal government that he/she knows or should know is false.
3. Civil penalty of not less than \$5,000 and not more than \$10,000, plus 3 times the amount of damages which the Government sustains because of the act of the person.

Policies – Tracking Unallowable Costs

1) Federal Acquisition Regulation Part 31 Compliance Policy

It is the company's policy to maintain records in a manner that complies strictly with Federal Acquisition Regulation (FAR) Part 31 guidelines. In doing so, the company will continue to structure its accounting system in such a way that we achieve the following broad objectives:

Properly charge all project-related expenses to the appropriate projects, and record such expenses in direct cost accounts

Direct cost accounts are, by definition, not part of the company's overhead expenses and not included in our overhead rate. For reasons of practicality, certain direct costs which are inconsequential in amount are accounted for as indirect costs in accordance with FAR 31.202.

Segregate indirect cost accounts as either "FAR-allowable" or "FAR-unallowable"

This is done in accordance with FAR guidelines concerning allowable and unallowable indirect costs. In cases of indirect cost accounts that include both allowable and unallowable indirect costs, Metcalf will review these accounts both on a monthly and annual basis and maintain a record of expenses to be disallowed.

We perform monthly and annual general ledger reviews to check compliance with these instructions, and these reviews pay particular attention to the items identified under the next section of this document, titled "FAR Compliance Procedures".

2) Federal Acquisition Regulation Part 31 Compliance Procedures

The company's Federal Acquisition Regulation ("FAR") Compliance Procedures are designed to accomplish the following objectives:

- Maintain accounting records such that project costs, FAR-allowable overhead costs, and FAR unallowable overhead costs are properly segregated
- Establish and maintain appropriate levels of review to ensure FAR compliance General Procedures to ensure FAR compliance:
- All company staff involved with recording and reviewing expenses are familiar with FAR expense allowability guidelines and have access to additional resources as necessary to evaluate FAR allowability. This includes the Principal, Accounting Manager, and accounting staff.
- The Accounting Manager, accounting staff, and Principal work closely together to determine the proper treatment and coding of expenses.
- Management communicates to employees the company's strict policy that all project hours and related labor costs must be properly recorded to the project, even if the costs are not billable to the client, or result in the project being over budget.
- The accounting group performs additional review of company's General Ledger on a monthly basis to identify other unallowable expenses or project-related charges included in allowable accounts. As a result of this review, adjusting journal entries are recorded when necessary.

Policies –

The company has created accounts to better segregate FAR allowable and unallowable expenses. The costs in the FAR unallowable accounts are not included in company's overhead rate. The accounts, as well as descriptions are as follows:

Entertainment/Gifts - FAR Unallowable

Description: Costs of amusement, diversion and social events; also including costs of alcoholic beverages, insufficiently documented meal receipts and employee gifts.

Marketing Trade Shows - FAR Unallowable

Description: Costs incurred for booths at trade shows.

Website Design/Maintenance - FAR Unallowable

Description: Costs related to company website costs, not specifically for help wanted advertising for specific positions. Note that a portion of website costs related to recruiting pages, client portals or file sharing / FTP sites may be allowable and should not be recorded to this account.

Marketing Material/General Events - FAR Unallowable

Description: Costs related to promotional material or public relations events other than Trade shows

Other FAR Unallowable

Donations- FAR Unallowable

Description: Donations to charitable organizations and sponsorships of professional organizations. Costs of certain community service activities, such as employee participation in blood drives or community service events, however, are allowable and should not be recorded in this account.

Interest Expense - FAR Unallowable

Description: Interest expense on loans, lines of credit, company credit cards or any other form of financing are unallowable under FAR.

Bank service charges do not represent interest, and should not be recorded in this account.

Bad Debt Expense - FAR Unallowable

Description: Write-off of uncollectible accounts receivable, including bad debt expense recorded representing increases in the allowance for doubtful accounts.

Travel Expense in Excess of FTR - FAR Unallowable

Description: Portion of travel costs that are in excess of amounts allowable under FAR. Includes, lodging expenses that exceed the applicable Federal Travel Regulation per diem limits and special request airline seating.

Common FAR-Unallowable Costs

Common FAR-Unallowable Costs

31.205-1 & 31.205- 38(b)(1)

Advertising - print advertising, portion of company websites for general promotion. Does not include help wanted advertising for specific positions, which is an allowable cost.

31.205-1(f)(2)

Trade Show Expenses - cost of booths at trade shows or conventions used for promotion of company services.

31.205-1(f)(2)

Trade Show Labor - labor costs related to staffing booths at trade shows or conventions to promote the company's services to the general public.

31.205-1(f)(5)

Brochures and Other Promotional Material - printed materials promoting the company to the general public are unallowable. Proposal materials for specific projects are allowable, however, as bid and proposal costs.

Policies -

31.205-1(d)(2)

Souvenirs/Imprinted Clothing Provided to Public -

generally, clothing or items printed with the company's logo or name and provided to the public are an unallowable cost. However, uniforms worn by company employees are allowable.

31.205-1(f)(7)

Membership in Civic and Community Organizations

- membership in certain community or civic organizations without a specific business purpose is an unallowable cost. However, membership in professional organizations such as engineering industry organizations (ACEC, etc.) are allowable to the extent the dues do not represent lobbying activities. Closely examine dues invoices for information on the portion (if any) allocable to lobbying activities - that portion is unallowable

Policies -

31.205-3

Bad Debts - write-offs or allowances for write-offs of bad debt are unallowable costs.

31.205-3

Collection Costs - any costs related to collection of bad debts are unallowable. However, labor costs incurred by employees in the course of normal A/R collections not specifically related to bad debts are allowable.

31.205-6(m)(2)

Personal Use of Company Vehicles - employee use of company vehicles should be recorded using mileage logs, and any portion that is for personal use is unallowable. Project-related mileage should be recorded to the applicable project.

31.205-8 & 31.205-1(e)(3)

Contributions or Donations - contributions or donations to charitable organizations are unallowable.

31.205-13(b)

Employee Gifts and Recreation - costs of gifts to employees, recreation activities, and parties are unallowable.

Policies -

31.205-14

Membership in Social, Dining, and Country Clubs - these costs are unallowable.

31.205-14

Social Activities - all activities should be examined for business purpose. Activities that are primarily entertainment, such as parties, golf, sporting events, or similar activities are unallowable costs. The labor cost of employees engaging in these activities should also be recorded as unallowable.

31.205-15(a)

Fines, Penalties, and Costs Related to Violation of Laws - these costs are unallowable, and include costs such as tax penalties and parking tickets

31.205-19(e)(2)(v)

Life Insurance on Key Employees - the costs of life insurance on senior executives is allowable if 1) the company is NOT the beneficiary, and 2) the life insurance premiums are recorded as compensation to the executive

31.205-19

Costs to Correct Defects in Materials and Workmanship - costs incurred to correct errors in project design should be treated as either unallowable overhead costs or a direct cost of the project.

Policies -

31.205-20

Interest Expense - interest expense and any costs incurred in obtaining financing, including annual renewal fees on lines of credit are unallowable.

31.205-22

Lobbying and Political Activity Costs - these costs are unallowable. It is important to examine professional dues invoices for PAC contributions and any portion of the dues that relate to the organization's lobbying efforts; such amounts are unallowable.

31.205-27

Organization/Reorganization Legal Fees - any fees related to mergers, acquisitions, or corporate organization or reorganizations are unallowable, including related labor costs incurred by employees in these activities.

31.205-35

Relocation Costs (in certain circumstances) - costs of relocating employees are generally allowable, but are subject to specific restrictions in accordance with the referenced FAR section. These costs should be examined closely for allowability.

Policies -

31.205-46

Travel Costs in Excess of FTR Rates -the Federal Travel Regulations establish allowable daily rates for lodging, meals, and incidentals for overnight travel. The applicable rates by travel destination may be accessed at www.gsa.gov by clicking on Per Diem Rates in the top left corner of the page, then entering the city and state. Meals and incidentals for the first and last day of travel are limited to 75% of the stated per diem rate.

31.205-49

Goodwill -write-offs or write-downs of goodwill or other intangible assets are unallowable.

31.205-51

Alcoholic Beverages -costs of alcohol should be noted on any meal receipts, and such costs should be recorded as unallowable, separately from the rest of the meal.

Hiring a CPA firm to perform the audit

There are many factors involved in selecting a CPA to perform an overhead audit.

Does the Firm:

- Meet all Generally Accepted Government Auditing Standards requirements
- Follow AICPA Professional Standards
- Received a favorable peer review report.
- Be well versed in GAGAS, Cost Accounting Standard, and related laws.
- Have adequate experience in applying GAGAS
- Have a working knowledge on the industry
- Be well versed in job-cost accounting practices
- Have experience performing FAR- compliant audits.
- Have knowledge with Government Procurement and payment terms

Asking for Raises

What is your policy?

- Proposal Phase
- Contracting Phase
- Billing Phase

Tax Relief for Engineering Firms

Sec. 199A of the Internal Revenue Code affords owners of sole proprietorships, partnerships and S corporations (and some trusts and estates) a lucrative 20 percent deduction on their qualified business income (QBI) beginning in tax year 2018. Sec. 199A deduction does not apply to SSTBs when taxable income is above \$426,600 for joint filers and \$213,300 for other filers. Engineering firms are not considered a specified service trade or business (SSTB)

Payroll Protection Program

If you received a PPP, a portion of the PPP loan forgiveness may have to be credited to your overhead rate. The credit can be significant!

Resources

- 2016 American Association of State Highway and Transportation Officials (AASHTO) Uniform Audit and Accounting guide.
 - Appendix B – Internal Control Questionnaire.
 - DCAA Audit Manual



QUESTIONS?