Federal government contractors industry developments - 1992; Audit risk alerts

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Federal Government Contractors
Industry Developments—1992

Update to AICPA Audit and Accounting Guide
Audits of Federal Government Contractors

AICPA
American Institute of Certified Public Accountants
NOTICE TO READERS

This audit risk alert is intended to provide auditors of financial statements of federal government contractors with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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Federal Government Contractors
Industry Developments—1992

Industry and Economic Developments

Many federal government contractors are dependent on commercial airplane orders and on Department of Defense (DOD) and National Aeronautics and Space Administration (NASA) budgets. In the last several years, economic and political pressures have had significant negative impact on the business base of these and other federal government contractors. As a result, considerable attention has been focused on issues such as—

- Downsizing of the DOD and NASA budgets.
- Industry consolidation, restructuring, and downsizing.
- Major contract cancellations and terminations.
- Performance on fixed-price contracts, including research and development contracts.
- Manufacturing quality and efficiency.
- Regulatory requirements, business image, and government investigations of contractors.
- Global competition.
- Strategies for alternative uses of technology in the commercial marketplace.

The continuing sluggish economy, recent and planned DOD and NASA budget cuts, and the significant economic and political changes that continue to take place worldwide are creating a declining business base for defense and aerospace contractors. This decline in available contracts is increasing competition among contractors while creating significant pressure to reduce costs. Most industry experts forecast continued downsizing and industry consolidation by aerospace and defense firms trying to remain competitive by attaining more efficient cost structures.

Many contractors are accepting greater financial risk in the work they perform. In many cases, suppliers also have been required to assume greater risk in order to maintain their business base. The auditor should consider these and other factors in evaluating the likelihood of recovery on contracts and in evaluating whether there is substantial doubt about the contractor's overall ability to continue as a going concern.
Because of government-customer budget constraints, many contractors are experiencing increases in claims activity related to the cancellation of contracts. Contractors are also encountering situations in which requests for equitable adjustment are being denied because there are no funds available to cover the costs of constructive change orders. Additionally, a number of aerospace and defense contractors are experiencing significant performance difficulties on major weapons development programs and are projecting significant cost overruns. Some contractors have filed, or are in the process of filing, contract claims to recover additional costs. Auditors should carefully evaluate contractors' recorded claims and requests for equitable adjustment amounts in process at year end to determine the likelihood of recovery based on evidence relating to both the contractor's legal entitlement and the availability of funds for payment.

Regulatory Developments

Cost Accounting Standards Board Initiatives

In April 1992, the Cost Accounting Standards Board (CASB) issued a rule to recodify into a single set of uniform regulations those cost accounting standards (CAS), rules, and regulations previously promulgated by other bodies that are applicable to covered government contractors and subcontractors. The rule did not result in the promulgation, amendment, or rescission of any new or existing cost accounting standards.

The cost accounting standards are applicable, in full or in part, to all negotiated federal contracts and subcontracts of $500,000 or more. Accordingly, contractors whose contracts are only with nondefense agencies generally must comply with CAS requirements if they meet the minimum CAS threshold.

The CASB has also issued Staff Discussion Papers concerning proposed revisions to CAS No. 412, Composition and Measurement of Pension Cost, relating to the measurement and assignment of the costs of unfunded pension plans to government contracts, accounting for the pricing of fully-funded defined-benefit pension plan costs in government contracts, and the recognition and pricing of changing capital asset values resulting from mergers and business combinations.

Cost Allowability and Allocability Issues

There are several areas in which government auditors frequently raise cost allowability and allocability issues. Some of these areas include the following:

Revaluation of Assets in Business Combinations. A Federal Acquisition Regulation (FAR) cost principle (Section 31.205-52, "Asset Valuations Resulting
from Business Combinations") is now effective for certain contracts that
define as unallowable costs depreciation, amortization, and cost of money
on depreciable property and gains and losses on its disposition that result
from a business combination when the purchase method of accounting is
used and the related assets have a step-up in basis.

*Litigation Costs.* The federal government may challenge the allowability of
legal costs associated with disputes, claims, and consent decrees when viola­
tions of federal statutes are involved. Current cost principles (FAR Section
31.205-47, "Costs Related to Legal and Other Proceedings") indicate that all
costs associated with the defense of fraud and certain other proceedings are
unallowable. Contractors are responsible for identifying and excluding such
costs from claims for cost reimbursement and in contract pricing.

*Research and Development.* Because of the nature of certain joint-venture
teaming arrangements, the federal government may challenge whether
costs incurred in research and development are contractually covered,
and whether they are eligible for recovery by any member of the venture
or team as part of its independent research and development costs. In
addition, because cost allocations associated with joint ventures generally
are based on considerations that require judgment, they are often subject
to increased scrutiny when advance agreements with the government
have not been negotiated.

The federal government is also closely reviewing independent research-
and-development-type costs and their classification as independent
research and development or contract charges. When contractors perform
tasks on a contract that are similar to tasks performed under independent
research and development activities, a potential exists that the classifica­
tion of independent research and development expenses will be chal­
lenged on the basis of a theory that costs may be more properly charged to
a contract.

*Uncompensated Overtime.* The federal government has challenged costs
allocated to contracts in instances in which contractors have a significant
volume of uncompensated overtime for salary-exempt personnel. In addi­
tion, the traditional 2,080-hour base year for computational purposes may
be challenged when the contractor's normal work year is substantially
higher in hours.

*Marketing and Selling Costs.* The federal government may challenge the
allocability of certain marketing and selling costs to government contracts
when a contractor sells both commercial and government products and
assigns those costs to the same indirect cost pools. Specifically, the govern­
ment may claim that certain costs should be charged to the contractor's
commercial business base.
Environmental Cost Issues. The allowability of environmental costs has received increasing attention from DOD and Congress. A proposed environmental cost principle has recently been cleared for issuance for public comment. The proposal would divide environmental costs into two categories: (1) ongoing prevention and disposal costs, and (2) costs of correcting environmental damage. Costs in the first category generally would be considered allowable. However, allowability of costs in the second category would be based on the contractor's demonstrating that it (1) was performing government contracts at the time the conditions were created, (2) was conducting business prudently and in compliance with laws and regulations, (3) acted promptly to minimize damage, and (4) has diligently pursued legal and contributory sources (for example, insurance or indemnification) to defray the cost. Auditors should be alert to the issuance of any new standards in this area.

Idle Facilities Costs. The considerable consolidation and downsizing within the industry are likely to cause certain facilities to become underutilized or idle. Under FAR Section 31.205-17, "Idle Facilities and Idle Capacity Costs," the costs of idle facilities that were necessary when acquired are allowable for a reasonable period of time, ordinarily not to exceed one year. In the current environment, contractors may require longer than one year to successfully find alternative uses for, lease, or otherwise dispose of the facilities. The auditor should consider individual facts and circumstances in considering how reasonable a period of time is with respect to idle facilities costs.

Executive Compensation. FAR Section 31.205-6, "Compensation for Personal Services," establishes a range within which compensation must fall to be considered "reasonable" and therefore qualify as an allowable cost for contract costing. Under this principle, once the government has challenged the reasonableness of an element of compensation, the contractor has the burden of demonstrating that the cost is reasonable. Contractors may seek the assistance of compensation experts in responding to those challenged costs.

Auditors should be alert to the facts and circumstances relating to costs, such as those described above, that are charged to contracts.

Department of Defense Initiatives

Certified Cost and Pricing Data. The Director of Defense Procurement issued a memorandum that clarifies the DOD policy regarding when certified cost or pricing data should be obtained for DOD contracts. Specifically, certification of cost or pricing data is not required when the contract price is based on adequate price competition or established catalog or market prices of commercial items sold in substantial quantities to the
general public, or is set by law or regulation. In addition, prime contractors are not required to obtain cost or pricing data from subcontractors if such information is not obtained from the prime contractor.

Recoupment of Nonrecurring Costs. The DOD has issued interim and proposed rules on the recoupment of nonrecurring costs on direct foreign sales or foreign licensing of U.S. items. The interim rule, effective June 26, 1992, abolishes recoupment fees on all products other than major defense equipment (defined as any item of significant military equipment on the United States Munitions List having nonrecurring research, development, test, and evaluation costs of more than $50 million or total production costs of more than $200 million) exported for military use. Auditors should be alert for final guidance issued in this area.

Bid and Proposal Costs. In 1992, the DOD issued a final rule which amends FAR part 31.205-18, "Independent Research and Development and Bid and Proposal Costs," which eliminated its bid and proposal ceiling formula for contractor fiscal years beginning on or after October 1, 1992. For contractors with less than $10 million of annual independent research and development (IR&D) and bid and proposal (B&P) costs allocated to flexibly priced DOD contracts, no ceilings will exist after this date. For contractors with more than $10 million in annual IR&D and B&P costs allocated to flexibly priced DOD contracts, the ceiling will be phased out over a three year period. For each year during the transition, the allowable cost will be based on a 5 percent growth rate and an additional increase for the effects of inflation. As a result, many contractors may assume they have the right to unlimited bid and proposal cost recovery. However, these costs are only allowable to the extent that they are allocable and reasonable. If a contractor's bid and proposal costs increase dramatically, the Defense Contract Audit Agency (DCAA) and other cognizant audit agencies have the authority to question the reasonableness of and disallow excessive bid and proposal costs. Auditors should evaluate the reasonableness of these costs and the related likelihood of recovery.

Audit Issues and Developments

Claims, Change Orders, and Requests for Equitable Adjustment (REA). In the current environment, it is likely that contractors will encounter significantly more claims activity, either with the government or subcontractors. The claims may result from (1) contract performance problems and concerns, (2) letter contracts or other expedited procurement processes initiated by the government, or (3) government-initiated contract terminations, cancellations, or delays.
Auditors should discuss with appropriate client personnel the need for an opinion of legal counsel to support claims, REAs, and, where necessary, unnegotiated change orders, and should consider the contractor's past history in negotiating similar claims, REAs, and unnegotiated change orders when evaluating the estimated net realizable value of such amounts. Auditors should refer to the criteria for recognizing claims as set forth in the AICPA Audit and Accounting Guide Audits of Federal Government Contractors. Auditors should also consider the adequacy of financial statement disclosure for significant claims, REAs, and unnegotiated change orders.

Overhead Rates. Even as the business bases of many government contractors decline, some contractors may be experiencing increasing overhead rates as a result of charging idle personnel to overhead for extended periods. Auditors should pay particular attention to the reasonableness and likelihood of recovery of overhead rates in such circumstances. Many companies have significantly reduced their work force but find that additional cost-cutting measures are necessary to remain competitive. Auditors should consider operating plans that require or use unrealistic sales forecasts in order to absorb forecasted costs.

High-Risk Contracts. Contractors occasionally experience difficulty in performing on certain contracts and may believe that the government may be responsible to some extent for the problems. In those instances, contractors may include the effect of claims or other adjustments that they believe will result in additional revenues from the government in their estimates at completion. Such claims and adjustments may reduce the amount of the estimated loss on such contracts or avoid a reduction in the level of profit recognized. As a result, auditors should critically evaluate the evidence supporting the contractor's basis for claims and adjustments, especially in contracts on which the contractor is known to have had difficulty performing. Auditors should also carefully consider the adequacy of the financial statement disclosure of significant claims and unnegotiated change orders.

Accounting Estimates. A critical part of an audit of any federal government contractor is consideration of the integrity and credibility of the contractor's systems for determining estimates at the completion of contracts and the resultant revenue and profit to be recognized. Auditors should also evaluate contractors' methods of estimating progress toward completion. Generally accepted accounting principles (GAAP) allow contractors to use either input or output measures to estimate progress toward completion. Auditors should consider whether the method used by the contractor provides a meaningful measure of the extent of progress toward completion. Additionally, when evaluating the
appropriateness of combining contracts for accounting purposes, auditors should carefully evaluate whether the criteria specified in SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts, are met, and consider whether the ultimate effect of proposed combinations is to mask or otherwise defer the recognition of losses or result in an acceleration of revenues and profit.

Defective Pricing. The federal government has challenged contract costs and pricing that involve "soft" data, such as anticipated productivity improvements and other actions to control and decrease the cost of products that can ultimately result in a lower cost of procurement for the government. In several instances, government auditors have alleged defective-pricing claims as a result of an alleged failure to disclose all potential cost-cutting or productivity improvement plans at the time of contract negotiation. Contractors and their legal counsel believe that much of this information goes beyond the definition of "cost and pricing data" required to be disclosed. Auditors should inquire of management about this type of claim and other known defective-pricing claims by the government. Auditors should also consider whether potential cost-cutting or productivity improvement plans might affect estimates at completion and progress payment computations.

Cost in Excess of Contractual Funding. Many contractors, for various business reasons, will continue to perform on a contract and incur costs in excess of the government's current appropriation of funds. Auditors should carefully review such costs for recoverability and consider the potential need for a reserve against the ultimate collectibility of such costs.

Firm Fixed-Price Options. Contractors sometimes agree to provide additional production quantities of their products to the government under firm fixed-price options. In auditing contracts with such provisions, auditors should determine whether the government has a unilateral right to exercise the options, and evaluate both the probability that the options will be exercised and the contractor's ability to perform without incurring a loss. Generally accepted accounting principles require that anticipated losses on contracts be recognized when they become probable.

Legal Issues. In the current competitive environment, there are increasing numbers of allegations by the government of contractor fraud. Actions that once would have been considered errors are now being characterized as fraud. Contractors, as well as their auditors, should carefully and accurately document actions to minimize the possibility of future misunderstandings which would lead to allegations of fraud.
Accounting Issues and Developments

Pensions. In most cases, government contractors’ pension expense, determined in accordance with FASB Statement No. 87, Employers’ Accounting for Pensions, is different than the expense calculated in accordance with CAS No. 412, which is used to determine contract revenue. In some cases, the amount of the difference may be significant. Auditors should carefully review contractors’ reporting and disclosure of these differences. Auditors should consider FASB Statement No. 88, Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits, in evaluating the appropriateness of the accounting and disclosure of settlements of defined benefit pension obligations, curtailments of defined benefit pension plans, and for termination benefits.

Postretirement Benefits Other Than Pensions. FASB Statement No. 106, Employers’ Accounting for Postretirement Benefits Other Than Pensions, is likely to create another postretirement benefit (OPEB) cost that is greater than the expense allowed as a contract cost used to determine contract revenue. The full GAAP-calculated amount may be allowable if the contractor has elected to fully fund it and has used the cumulative-effect method in a prior year to adopt FASB Statement No. 106. A number of issues, including tax laws regarding deductibility of OPEB costs, changes in CAS, funding, negotiation of forward pricing arrangements with respect to OPEB expenses, and the timing of adoption of FASB Statement No. 106, may further complicate the allowability of such costs. In addition, auditors should be aware that the DCAA has taken the position that a change from the “pay-as-you-go” method of accounting for OPEB costs to that required by FASB Statement No. 106 may result in a change in cost accounting practice for contract costing purposes, which would result in the disallowance of any increased costs allocated to current contracts, including cost-type contracts. Some industry experts disagree with the DCAA’s position.

Some contractors have, on adoption of FASB Statement No. 106, recorded a related asset. The future recoverability of such asset, and the timing thereof, may have a significant degree of uncertainty resulting from—

1. The current industry environment and related business-base concerns when the OPEB expense is projected to be recovered via contract costing.
2. The computations and assumptions used (including the amounts and years in which the amounts are recovered) to support the asset, which may be subjective. For example, given the current environment, questions arise as to whether future contract values should include funded backlog, total contract backlog, loss contracts, contracts with small margins, or contract options.
Because of the significance of the uncertainties, auditors should carefully consider the appropriateness of recording any deferred costs (or, alternatively, revenues accrued) by contractors to account for the difference between FASB Statement No. 106 and CAS requirements related to OPEB costs.

**Commercial Nonrecurring Costs.** Many federal government contractors are moving into commercial markets and increasingly are using the program method of accounting for products manufactured for delivery under production-type contracts, which may result in the deferral of costs. Under this method, costs—other than research and development costs—are accumulated and accounted for by programs rather than by individual units or contracts. A program consists of the estimated number of units of a product to be produced by an enterprise in a continuing, long-term production effort for delivery under existing and anticipated contracts. Auditors should be aware that program accounting may be extremely difficult to implement because of the significant uncertainties associated with making the necessary estimates of number of units to be produced and sold, length of time to produce and sell, and associated production costs and selling prices. Additionally, the recoverability of the deferred costs is subject to a greater degree of risk and, accordingly, becomes more difficult to estimate in the current uncertain business environment. Program accounting is further discussed in paragraphs 3.57 through 3.60 of the AICPA Audit and Accounting Guide Audits of Federal Government Contractors.

**Environmental Costs.** Contractors increasingly are faced with significant costs related to environmental cleanup activities. In some cases, contractors may be able to recover all or a portion of these costs depending on the treatment of the costs in future overhead rates. Auditors should consider the treatment of cleanup costs in future overhead rates when assessing a contractor's financial reporting related to environmental cleanup matters. *Audit Risk Alert—1992* includes a detailed discussion on accounting for and disclosure of environmental cleanup costs.

**Business Restructurings.** The uncertain economic and business environment is necessitating the reorganization, restructuring, and downsizing of many government contractors. Contractors involved in business restructurings are finding it advantageous to secure advance agreements with the government for the treatment of such costs. However, there are still conflicts between GAAP and the FAR related to the accounting treatment of certain items, such as pension curtailments and settlements. Auditors should be aware of these differences and should consider the related accounting and reporting issues involved in business restructurings of government contractors.
This Audit Risk Alert supersedes *Federal Government Contractors Industry Developments—1991.*

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Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1992,* which was printed in the November 1992 issue of the *CPA Letter.*

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