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Accounting Systems Webinar Q&A

Question: What do you consider a large versus small contractor?

RGCI Response:

I was primarily referring to the way DCAA classifies contractors. DCAA classifies contractors as either major or nonmajor. Major contractors are contractors with over $250 million of auditable dollar volume (ADV). ADV is the cost of flexibly priced Government contracts a company incurs during their fiscal year. The nonmajor category includes both small businesses under Small Business Administration (SBA) criteria that are exempt from Cost Accounting Standards (CAS) (and therefore do not have "Covered" contracts and larger businesses that have less than $250 Million ADV but don't qualify as small businesses and therefore may have "Covered" contracts depending on the size of negotiated government contracts they have been awarded. Qualification as a small business criteria depends on the North America Industry Classification System (NAICS) code under which the contractor does business. Each NAICS code has different criteria generally based on Revenue and/or number of employees.

Question: Is this slide heading wrong? This is post-award right?

RGCI Response:

Yes, I apologize for the error. The slide headings for slides 23-25 should be Post-Award instead of Pre-Award. I copied the pre-award slides as I was preparing the presentation to ensure that I identified those requirements that were different from the Pre-Award requirements and neglected to update title as I added the post-award requirements.

Question: How can you wrap warranty expenses into overhead rates when they're not allowed as a direct expense?

RGCI Response:

The nature of warranty costs makes this area somewhat tricky. The point I was making was that warranty costs are not automatically unallowable. FAR under FAR 31.205-39 specifically provides that "When not inconsistent with the terms of the contract, service and warranty costs are allowable." There are some contracts that specifically prohibit warranty in the terms and conditions of the contract. Otherwise, warranty costs are legitimate costs and you need to be able to recover those costs on your contracts. While warranty costs apply to the specific products or services sold under particular contracts, the actual costs of the warranty is not necessarily driven by the performance of the contract and can vary significantly from one contract to another. For that reason, some contractors find it more appropriate to treat warranty costs as indirect costs of manufacturing rather than direct costs of the contract. Therefore, treatment of warranty costs as other direct costs (ODCs) or as indirect costs depends the nature of the warranty costs and on each contractor's system. You are required to be consistent, in general, unless the costs are incurred under demonstrably different circumstances, you cannot charge warranty as a direct cost on one contract and allocate it as an indirect cost on another contract. FAR 31.205-39 also provides that a contractor should not be allowed to include service and warranty costs as components of both estimated product cost and of product risk because, by doing so, the contractor receives a windfall equal to the estimated warranty cost. This is a case of double compensation for the same expense. You need to be careful that you are not proposing warranty as an expense and also including it a risk component in trying to justify the fee.

It seems counterintuitive that you could charge warranty as an ODC because, obviously, the government is not going to pay the contractor more for honoring its warranty because it would pretty much defeat the purpose of having a warranty. Certainly, if you were talking about a cost-type contract, it would be very problematic for the government to reimburse the costs as an ODC. Even if the costs were recoverable as an ODC, that would require keeping the contract open until the warranty period expired which could also be problematic.

Fortunately, there are very few cost-type contracts where a warranty would be applicable due to the same uncertainties that lead to the contract being cost-type to begin with. If you should have cost-type contracts where warranty costs apply and warranty costs are accounted for as ODCs, I would recommend you consider changing that practice to include these costs as an indirect cost. Otherwise, it is impossible for you to recover the costs.

Most contractors that account for warranty as an ODC, do not have cost-type contracts where warranty costs are applicable. In those cases, the contractor tracks the actual warranty costs by contract and uses the historical costs to estimate the costs of warranty on future contracts. These costs are then included in the pricing of these contracts (generally fixed-price) as an ODC which is considered to be an allowable cost.

Again, in many cases, warranty costs are not driven by contract performance but are rather a function of the production process and it is virtually impossible to predict which particular product may fail and have to be replaced under warranty. In that case, it is better to classify these costs as indirect costs of the production process and recover the costs through the indirect rates (generally manufacturing overhead) rather than as an ODC.

Whether direct or indirect, the costs of warranty are still allowable if they are consistent with the terms of the contract. We have also had some issues with auditors erroneously questioning warranty costs as a contingency. Warranty costs are not contingencies under the provisions of FAR 31.205-7.

Question: How do you manage travel arrangements that are purchased in advance of travel for out of period costs?

RGCI Response:

Travel expenses that are purchased in advance should be accounted for as pre-paid expenses (asset) and expensed when the travel is actually incurred. Effectively, you would credit the prepaid expense and debit the travel expense account when the travel was actually used.

Question: One of the attendees pointed out that progress payments based on milestones also requires an approved accounting system.

RGCI Response:

You are absolutely correct. Thank you for pointing that out!