JAMESON & COMPANY

UNDERSTANDING THE BASIC ACCOUNTING REQUIREMENTS FOR FEDERAL GOVERNMENT AWARDS

Congratulations on receiving a federally funded award. Now comes the tricky part—managing the funds properly. To stay out of trouble and position yourself for additional funding down the road, you'll need to make sure that your accounting system meets specialized Federal compliance requirements, including being able to demonstrate that your indirect cost allocation methodology is fair and equitable, and can survive government audits.

UNDERSTANDING HOW THE FEDERAL GOVERNMENT DOES BUSINESS

When you receive a grant or contract from the United States government, you are entering into a business relationship with the largest purchaser of goods and services in the world. One that is highly sophisticated, with written and unwritten rules and expectations, and stiff consequences when not satisfied.

In general, the government will purchase goods and services by one of three methods.

1. **On a fixed price basis.** For example, contractors sell commercially available items to the government though the General Services Administration (GSA) schedule or Other Transaction Authorities (OTAs).

2. **On a time and materials basis.** For example, services can be contracted to a specific government agency at a fixed hourly rate and may be subject to the Service Contract Act.

3. **On a cost-reimbursable basis.** For example, Research and Development (R & D) and projects that have potential, but not satisfactory existing commercially-viable solutions.

This whitepaper will provide a high-level overview of the specialized accounting required of cost-reimbursable awards so you can make informed decisions about the proper oversight of your accounting system. Regardless of whether you've received **contract** or **grant** funding, this whitepaper will use the "award" vernacular, as we will be discussing basic concepts required by both types of funding vehicles. In general, cost-reimbursable awards require your accounting system to comply with Federal Acquisition Regulation (FAR) Part 31 and 45 CFR 75, sub part E.

COST-REIMBURSABLE AWARDS AND THE REQUIREMENTS THAT COME WITH THEM

Cost-reimbursable awards come from a variety of agencies, in a number of sizes, and with standard and unique reporting requirements. If you have a federal contract or grant containing FAR clause 52.216-7 Allowable Costs, the award is a cost-reimbursable-type funding vehicle.In a DoD contact, this clause if easy to spot in a 2 or 3 page list of FAR clauses that your award is subject to - in a document that is typically 30 pages or longer.

For NIH and DOE grants, this clause is trickier to find. A Notice of Grant Award (NOA) typically comes as a 3 or 4 page .pdf which takes you to the specific agency's supplemental regulations:

NIH Award term and conditions are embedded in a hyperlink to **http://grants.nih.gov/grants/policy/awardconditions.htm** which ultimately takes you to 45 CFR 75, subpart E. DoE Awards drive you to **ecfr.gov**. These awards are typically subject to three levels of regulations:

Level 1 ●○○

If you've received one of these awards, you'll need to establish an acceptable accounting system and maintain in an "always audit-ready" manner. Regardless of the exact type of federal award vehicle, all are subject to the accounting and administrative requirements and guidance contained in the Federal Acquisition Regulation (FAR) and Cost Accounting Standards (CAS).

Level 2 ●●○

Each government agency has the right to issue its own supplemental regulations. The Department of Defense, National Institutes of Health, and Department of Energy all have substantial supplemental regulations.

Level 3 ●●●

Different types of program awards may carry specialized funding vehicle regulations. As an example, the SBIR program requires certain ownership requirements and the Principal Investigator (PI) is required to derive the majority of his salary from the entity receiving the award. ARPA-E's carry cost-sharing requirements that are generally not found in SBIRs.

As a basic overview, this whitepaper only addresses "Level 1" subject matter—general overview accounting and administrative requirements required by the FAR and CAS.

The Bottom Line

The government is willing to pay for all fair and reasonable costs within the constraints of their guidelines. In general, you will need to know whether a cost is allowable (as a direct or indirect expense) or unallowable. You will need to set up and maintain an acceptable accounting system. And it is your responsibility to keep meticulous supporting documentation in order to demonstrate your accumulated project costs to a government auditor.

The following types of program awards almost always have FAR 52.216-7 embedded in the terms and conditions of their award:

- BARDA
- ARPA-E
- IDIQ
- BAA
- SBIR/STTR Phase II
- R01/U01/R21
- NIH SBIR/STTR Phase I*

WHY THE GOVERNMENT SEES YOUR AWARD AS HIGH RISK

When the technical specifications of the work to be done can't be clearly defined, as is the case with the majority of R & D projects, the government will use a cost-reimbursable award vehicle. This is considered a high-risk "level of effort" contract because of the potential for cost escalation because the government will pay the grantee's cost of performance whether the outcome of the project is satisfactory or not.

In most businesses, the higher the risk, the greater the need for oversight. The same is true of the government. If you have a cost-reimbursable award, you need to understand which regulations apply to your situation—there are literally thousands of pages. **The government does not protect your interests. You do.**

Is it important to understand that with cost-type awards the government has financial recourse back to you until all audits are done and the project is closed-out. Getting this wrong can be extremely expensive.

GETTING STARTED

Setting Up Your Accounting System

While some of our clients require more sophisticated systems, low-cost, off-the-shelf software packages such as QuickBooks online help satisfy the basic accounting requirements that your government award demands. The first key to using this software compliantly is to properly setup the chart of accounts. Unfortunately, there isn't a "government contracting" standard chart of account option in QuickBooks online software. We offer several levels of **solutions**.

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PHASE I

Setting Up the Right Chart of Accounts

Your chart of accounts is a list of all the accounts used to organize your business financial activity into different groupings of assets, liabilities, income and expenses. The numbering of your accounts is strongly recommended as it creates a simple, consistent cost coding language, and assists in creating a cost charging language throughout your organization. If set up correctly, your chart of accounts will streamline your ability to accumulate and report on costs, and save you hours of guesswork and headaches hunting down explanations from your employees.

Your monthly government billings and annual incurred cost submission are generated from detailed, concise job cost reports. The chart of accounts forms the foundation for gathering all this information. When the government auditors arrive, your paperwork needs to clearly document the expense incurred, and the supporting documents must authenticate the transaction and approval process. **Being audited is not storytelling time or a time to fumble around looking for answers!**

Manage Your Expense Charge Coding and Documentation

The next step in demonstrating your acceptable accounting system to a government auditor is the ongoing ability to segregate the expenses in your general ledger as either Allowable (government will reimburse you for these) or Unallowable (they will not.)

Allowable Costs

DIRECT COSTS

Any costs for goods or services that are specifically and only for the benefit of ONE government (or commercial) project, such as:

- ✔ Direct Labor: As an example, the cost of several hours that an engineer spends performing an experiment that benefits one specific project
- ✔ Direct Materials
- ✔ Direct Subcontractor Costs

INDIRECT COSTS

Any costs for goods or services that benefit multiple projects are indirect expenditures such as:

- ✔ Utilities
- ✔ Indirect labor, including vacation, holiday and sick time
- ✔ Administrative labor costs
- ✔ Accounting fees
- ✔ Telephone and internet expenses
- ✔ Rent (assuming you don't have specialized facilities)
- ✔ Some legal fees

Unallowable Costs

Expenses that the government specifically will not reimburse you for as they do not derive benefit from these costs. Examples include, but are not limited to:

- ✘ Alcohol
- ✘ First class travel (costs in excess of per diems)
- ✘ Federal income taxes
- ✘ Donations
- ✘ Fines, penalties, late fees

The classification and coding of expenses are critical and can be confusing at times. While some costs are black and white, others may fall into gray areas. In these situations, a good line of reasoning is to ask yourself:

If it weren't for this project, would we have incurred this expense?

Which projects benefit from incurring this expense?

In general, costs that only benefit a specific project are direct expenses and costs that benefit "the business" are indirect expenses. Our experience shows that 98.3% of new award winners dramatically underestimate their indirect costs. More important, they fail to understand that the government prefers to do business with companies who continue to advance their resources and solutions.

Keeping Close Track Of Labor Costs—Timesheets Are Mandatory.

Labor costs are usually THE largest expense for R & D projects. This is not lost on the government. As such, the government mandates that every employee who works in your company that you charge the government for, either directly or indirectly, needs to maintain a timesheet. These timesheets must include all of the active projects that your employees are working on, both government and commercial, as well as charge categories to account for indirect labor, such as vacation, holidays, sick and administrative time.

It is also a FAR requirement for your company to have the following timekeeping policy:

- Timesheets must be prepared in ink
- Employees must record all time spent (even if in excess of 40 hours/week)
- Employee must sign off on all timesheets and must get their supervisor's approval
- Any corrections must be handled as follows–do not erase anything, draw a line through any errors and write in the correct information, initial and date the correction.

In practice, your time-tracking system can be either manual (paper) or electronic. The government doesn't make blanket approvals for commercially-available electronic time-keeping systems. However, to be considered acceptable by a government auditor, an electronic system must provide a date-stamped audit log for all data entry including changes and approvals—which effectively creates a forensic trail.

Obviously, the government doesn't want anyone to manipulate the actual labor costs.

When grantees are just getting their business started we typically advise them to simply pay themselves an hourly rate for all their recorded time. Paying salaries introduces the possibility of uncompensated overtime, which can complicate matters. Check out our blog series on this topic.

Job Cost Reporting

All of your expenses must be accumulated in your general ledger (with the assistance of a good chart of accounts) and must reconcile with your job cost reports, a form of subsidiary (or additional) ledger. Job cost reports are critical for internal decision making, as well as external reporting requirements and will:

- Act as support for billing the government for incremental monthly project costs accumulated
- Be used to report cumulative spending by budget category to your customers which they use to monitor technical progress achieved on the goals of the project
- Provide a signal to management when to wrap up a project to prevent overspending

Indirect Cost Reports

Indirect costs come from expenses that relate to your overall business, which aren't incrementally caused by specific projects. They include electricity, rent, accounting and telephone expenses. These costs indirectly benefit all of your projects and need to be proportionally allocated, charged and "paid for" by all of your projects—government and commercial alike. If they all benefit from the rent, they should all pay for it.

All projects pay for these costs via an indirect cost recovery rate. Your indirect cost rate recovery methodology is what you believe to be the most fair and equitable way to proportionally charge these costs to all your customers on an ongoing basis. Once per year, the government requires you to prepare an incurred cost submission or "true up " report, which reconciles monthly indirect cost rate charges with actual indirect expenses.

Just because a government agency creates a cost proposal template in a certain terminology format does **not** mean you must adhere to their format! You need to determine the best methodology for recovering your indirect costs—especially if you are doing business with multiple agencies. We are typically advocates for keeping it as simple as possible.

Different government agencies will refer to indirect costs using slightly different terminology- fringe, fringe and F&A rates, overhead rates, overhead and G&A rates. These terms and their prescribed use in cost proposal forms are nothing more than methodology nomenclature common to that agency.

98.3% Underestimate Their Indirect Cost Rate

The indirect cost recovery rate that you propose to the government should represent the indirect costs that you need to fairly reimburse yourself for indirect expenses—that is your right. However, many companies underestimate this rate when they propose projects and do not charge the government anything resembling their actual rates because the competition for government funding is intense.

While undercharging the government for indirect expenses is legal, it is expensive as it leads to guaranteed project cost losses that need to be paid for somehow, and it may or may not be a good strategic idea. (The government will certainly not stop you from giving them a good deal. Conversely, if you overbill them they will require swift repayment of the overbilling.) **If you do not have equity backing or an extremely profitable commercial revenue stream undercharging for your actual indirect costs can be a swift for certain real road to financial ruin.**

For additional information on how to project the right indirect cost rate for your business, download our **free Excel template** and experiment on your own.

Cost-reimbursable Awards Mean Annual Incurred Cost Submissions

Regardless of whether you ask for an indirect rate that is too low out of gallantry, cowardice, or a purposeful strategic management decisions—you are never excused from calculating your actual indirect rates on a monthly basis or properly reporting them in order to demonstrate that you're under-billing your government customer. Each government agency has a slightly different approach to indirect cost rate negotiations. However, the annual incurred cost submission is one of the key historic reports used to negotiate your final indirect cost rate

The presence of FAR 52.216-7 in the terms and conditions of your contract or notice of grant award means you have a cost-reimbursable award. When you initially propose the project, you request an indirect cost rate in order to provisionally (temporarily) invoice the government on a monthly basis. The annual incurred cost submission is effectively a true-up report you must prepare which shows how you calculate your final, actual indirect cost rate. Once submitted you are required to reimburse the government for any indirect costs overbilled.

Each agency has slightly different Incurred Cost Submission reporting requirements. To understand how involved this report is, please visit our **DoD page**. In addition, we've highlighted variations in the reporting requirements on the **NIH** and **DoE** webpages.

Government Audits

Poor audit outcomes can result in delays in paying invoices, termination and repatriation of funding and, in the worst case, criminal and civil indictments. The depth of this topic is far too complex for this basic white paper. We've created an additional white paper titled, "Understanding the Strings Attached to Your Grant Award" for grant awardees which can be downloaded here.

UNDERSTANDING THE STRINGS ATTACHED TO YOUR GRANT AWARD

DOWNLOAD NOW

GETTING THE HELP YOU NEED: WHAT YOU NEED TO KNOW ABOUT CPAs

When you think accounting and audits, you probably think of your CPA. In general, CPAs are highly-educated licensed individuals who are well-versed in Generally Accepted Accounting Principles (GAAP). Today becoming a CPA generally requires a Masters' degree, passing a multi-day uniform exam, and at least two years of public accounting experience.

GAAP is the underlying business language used to produce financial statements. GAAP financial statements are used internally by management in making short and long-term decisions and improving business performance, and externally by investors and creditors in making investing in lending decisions. GAAP provides guidance on accounting for routine and non-routine transactions such as revenue recognition. A strong understanding of GAAP is fundamental to government grants and contract accounting.

The Internal Revenue Code, on the other hand, is the framework for corporate and individual income tax regulations. It is critical to a business. Because of this, management frequently turns to their tax CPA first. **Tax knowledge, however, is almost completely irrelevant to working with the cost accounting standards of Federal Acquisition Regulations.**

Do You Have The Right Kind Of CPA?

Government contract accounting is a rare specialty and, in truth, is outside the realm of knowledge of an ordinary CPA. It requires a deep and current understanding of Federal Acquisition Regulations (FAR), each agency's supplemental regulations, and SBIR/STTR regulations. A general accountant will not learn this area in school, nor is it covered in the Uniform CPA Examination.

Federal grants and contracts come with government audits. Make sure your CPA specializes in government award accounting, knows the federal and agency regulations, and can help you stay compliant. This is imperative to your funding, innovation, and business.

At Jameson, our Account Managers are typically CPAs with 10+ years of public accounting experience and they usually need about 5,000 to 6,000 hours of government award management experience before we will let them represent a client during a government audit without a supervisor present, depending on the type of audit. The stakes are just too high.

How To Tell If Your Accountant Is Qualified to Handle Your Needs

While knowledge of GAAP is the baseline for applying the specialized rules of FAR, it is only the beginning. There're many nuances to FAR accounting that can only be learned in the trenches. To see the person overseeing your financial relationship with the federal government is qualified, asking the following:

1. **Do you know what the salary cap is for our funding agency?**
   While the exact number generally changes annually, not having a rough idea– without looking it up– is very telling.

2. **How would you rank the difficulty of the different types of audits?**
   See our DCAA Audit whitepaper for what the right answer should sound like.

3. **How many indirect cost traits have you negotiated?**
   Final indirect cost rates are negotiated during the government's audit of your Incurred Cost Submission. Would you pick a knee surgeon for your operation who only had three successful operations or would you prefer someone who has performed hundreds?

Yes, there are all sorts of competent individuals who can help you with your business. But the question remains, are they qualified to help you with your government contract and grant accounting?

SUMMARY

Receiving a cost reimbursable award can be a real game changer. But there are strings attached in the form of reporting and accounting requirements specified in the Federal Acquisition Regulations and Cost Accounting Standards.

There are also requirements which are unique to different government agencies, and even the different types of funding vehicles. Audit findings, penalties, future funding, even the original award itself is riding on your accounting practices so you have to get it right.

To avoid expensive surprises, find an expert with a proven track record of working with government grants and contracts. Whether you decide to handle the accounting in house or outsource, make sure the person who oversees the care of your books and records, and represents you during these government audits understands the rigors of this type of accounting.

Know More

If you'd like to learn more about Jameson & CPAs, our team, experience and solutions, visit jamesoncpa.com.

Ready to get started? Contact a government award accounting expert today.

781-230-7304 SCHEDULE A CALL