

The Montana Innovation Partnership (MTIP) program powered by MSU TechLink Center assists tech-based individuals and companies to fund Research and Development (R&D) efforts and commercialize their innovations. Those companies engaging under federal grants and contracts will be required to become knowledgeable in the requisite government accounting. While acknowledging that this is a vast and complex field, the Government Accounting guide will initiate a fundamental understanding of key concepts.

WHAT IS IT

MTIP's Government Accounting guide will focus on small businesses engaging under the federal SBIR/STTR programs. It is written simplistically to convey the most basic level of government accounting information in which a company must be proficient if seeking a federal grant or contract.

When submitting a research proposal to the federal government agencies, companies will also submit a 'cost proposal' or 'cost volume' which is a proposed project budget suitably developed within the constraints of Federal Acquisition Regulation (FAR). Though Research & Development contracts have some flexibility for performance, there aren't accompanying rights to free spending. Small businesses must take responsibility for understanding core elements of government accounting and the underlying statutory standards, before submitting a proposal and contracting with a government agency.

WHY IT MATTERS

Contract Cost Principles apply to every federal contract (whether R&D, procurement or otherwise). For SBIR/STTR contracts, audit and enforcement efforts are performed by the agency contracting personnel and by the Defense Contract Audit Agency (DCAA) which supports many of the SBIR agencies. If accepting a contract from the government, a company must be aware of the regulatory environment in FAR Subpart 31.2, Contracts with Commercial Organizations (www.acquisition.gov/far/html/Subpart%2031_2.html). FAR is supplemented by many resources including the DCAA Contract Audit Manual and specific guidelines (DFARS) for contractors working with the Department of Defense.

Before a contract will be awarded, a company will complete paperwork affirming it has accounting that meets Generally Accepted Accounting Principles (GAAP) and that properly segregates Direct, Indirect and Unallowable costs (discussed further below). There must be good timekeeping practices for all labor, and sufficient internal written accounting policies and procedures. The DCAA website offers many checklists and tools for small businesses getting started working with federal agencies (http://www.dcaa.mil/audit_process_overview.html).

Ultimately, all federal contracts permit audit of the contracting company and its subcontractors. It is critical from the first contract to establish a model that will support further federal awards and demonstrate consistency in estimating, accumulating and reporting costs. If a company is not capable of representing a fundamentally acceptable accounting system, it is likely to be subjected to additional auditing efforts; and, awards, contracts and/or payments can be delayed or terminated.

IMPLEMENTATION

QuickBooks or most any accounting software can be designed and utilized for government accounting purposes. A search online will yield various government contract management solutions, timekeeping tools, and government contractor accounting software. The selected accounting approach must be able to segregate and accumulate costs directly associated with a specific contract or job or other revenue producing activity. A fundamental understanding of the following expense types is baseline knowledge for creating a cost proposal in response to a federal solicitation.

Direct Costs: These expenses are directly associated with each area of company productivity or revenue production and can be called "jobs" or "Direct Cost centers". In SBIR, these are costs that a company wouldn't experience but for having the SBIR contract. Direct Costs are further defined in FAR 31.202. Examples of Direct Costs include labor, materials, outside services, and travel. As a cost proposal is developed, a company needs to save all documentation of how it estimated the proposed costs for use in the contract information collection process (pre-award survey) prior to a contract being awarded.

Indirect Costs (IDCs): Costs defined in FAR 31.203 as being the underlying, ongoing costs of having a business. Examples include all the general costs of running a business including administrative and management labor, rents, telephones, office supplies, legal services, insurance and more. The IDCs may include or be grouped in different federal agency forms as General & Administrative (G&A) or Facilities & Administrative (F&A). All Direct Cost centers carry a proportionate part of the total IDCs (see example below under IDC Rate). It is critically important to establish an IDC Rate for a cost proposal even if the company is small and will only start off working one project in a year. This is an important indicator that the business is operating responsibly and with plans to attract additional job opportunities whether federal or non-federal.

Fringe Benefits: Every hour of labor also attracts a share of the company indirect costs for fringe benefits which can include payroll taxes, leave time, health insurance, bonuses and more. At the very minimum, a company will incur State and Federal Unemployment taxes and Social Security/Medicare on all wages. These payroll taxes alone can easily result in an additional 8% or more on every labor dollar. Fringe Benefits must be allocated to both the Direct Cost wages (labor to perform the contracted job) and the IDC wages (labor to support the business operations). For example, a company that paid out \$1,000 in wages will also be paying at least \$80 (8%) in payroll taxes. In this simple example, the Fringe Benefit Rate of 8% is applied to every payroll hour represented. If a bookkeeper for the business is hired for \$500/month that cost plus the company's 8% Fringe Benefit will add \$540 to the company's total IDCs.

IDC Rate: An IDC Rate is calculated to permit a share of the general costs of running the business to be applied to each job center or contract. This is a projected rate developed from actual past company financial data and a budget projection. Accordingly, there is no single 'correct' rate. Even the smallest one-person, one-contract company is expected to forecast the costs it anticipates during the contract period if it will claim IDCs to sustain company operations. The IDC Rate is the total (the pool) of anticipated indirect costs divided by the total anticipated Direct Costs (the base). The resulting IDC Rate ($\text{IDC Pool} / \text{Direct Cost Base} = \text{IDC Rate}$) is then applied evenly to the Direct Cost total incurred in each job or contract.

Consider for example, a company having only one 6-month contract (Job A) for \$200,000 in the coming year, though the general costs of running the business for that year will total \$40,000. The IDCs divided by the Direct Costs in this example yields a 20% IDC Rate for that year ($\$40\text{k} / \$200\text{k} = 20\%$ IDC Rate). This same company now sees strong potential for a second job (Job B) to also be awarded in that year bringing in another \$100,000 of projected Direct Costs and no increase to the company's projected IDCs. The projected Direct Cost base would then be a total of \$300,000 for the two jobs, and the IDC Rate would be projected at 13.3% ($\$40\text{k} / \$300\text{k} = 13.33\%$ rounded). Because each job shares in the support of the general costs of a business, that means the IDCs charged to Job A would total \$26,660 ($\$200\text{k} \times 13.33\%$) and the IDCs charged to Job B would total \$13,330 ($\$100\text{k} \times 13.33\%$). In this fashion, all jobs equitably share the general costs of doing business. Note that with more jobs and the Direct Costs associated with each job, the IDC Rate drops unless the added demand increases the company IDCs as well. A company must be alert to changes in its projection as the accounting year proceeds in order to correctly adjust management of the IDC Rate being applied to its contracts.

Some cost proposals and budget templates show a separate IDC Rate called Overhead. An Overhead Rate is applied only to a specified base of Direct Costs (such as labor) because of a beneficial or causal relationship between that base cost and the associated cost pool. A G&A rate (less the Overhead IDCs) is then applied to the subtotal of the Direct Costs plus Overhead. This adds a layer of precision and complexity that is not a required component in SBIR/STTR cost proposals and will not be further discussed in this Guide. The Overhead indirect costs can be rolled instead into the single IDC (or G&A) Rate as discussed.

Unallowable Costs: As detailed in FAR Part 31.2, Unallowables are costs that must be segregated from the Direct Costs and IDCs, and that are not allowed to pass through to the government contract under any circumstances. Examples include bad debt, interest expense, gifts, alcohol, lobbying and more. Circumstances directly related to the contract might cause other items to be unallowable such as overruns on the job costs contracted and on the travel costs that are allowed under Federal Travel Regulations. These same Unallowable Costs may be entirely allowable when computing annual business expenses for Internal Revenue Service tax filings. Therefore, a business may find it necessary to reconfigure financials being used for these two different federal purposes – government contracts and tax filings.

Profit/Fee: The government permits a company to reasonably profit under a contract. The profit is the only funding margin not subject to government restrictions related to Unallowable Costs as described above. The Profit can be very important to a company's ability to manage legitimate costs that are unallowable in government contract accounting. Under the SBIR/STTR rules, most agencies will permit a 7% profit/fee to be included in the cost proposal.

Below is a very simplistic example of how these accounting centers will appear in a \$200,000 cost proposal. A DCAA publication called 'Information for Contractors' can be found at www.dcaa.mil/DCAAM_7641.90.pdf. It provides further explanation of the application of accounting principles and includes additional examples of cost proposals.

Cost Element	Amount		
Direct Labor	\$120,000		
Fringe benefit @ 8%	\$ 9,600		
Direct Materials	\$ 14,163		
Outside Lab Services	\$ 10,000		
Travel	\$ 2,000		
<i>Subtotal Direct Costs</i>		\$155,763	
Indirect Costs @ 20%		31,153	
<i>Subtotal Direct Costs plus IDCs</i>			\$186,916
Profit @ 7%			\$ 13,084
Total			\$200,000

COMMON DEFICIENCIES

Companies need to review grant and contract guidelines specific to the sponsoring agency before developing a cost proposal. Deficiencies in the cost proposal and subsequent paper or verbal audits can slow or delay awards, contracting and payment. There must be excellent correlation between the technical proposal work plan text and the costs represented in the company budget. For example, if the cost proposal reflects a sum payable to a consultant, the proposal work plan must explain how that person fits into the project. Failure to do so can negatively impact the overall review and understanding of the proposal.

Furthermore, a company must be prepared to provide supporting data for all costs charged to a contract. Some of this detail might be discussed in a budget justification or narrative if permitted with the project proposal. Otherwise, it is critical for successfully moving through audit review. For example, all labor must be properly supported with time sheets that are signed by employees and maintained in an acceptable fashion, supported by written policies and procedures. Computational errors are unacceptable and can result in unwanted added attention. Finally, it is incumbent on all companies seeking a federal contract to be compliant with FAR requirements and to demand the same of their subcontractors.

If these requirements create an unacceptable burden, a small business is well-advised not to engage in federal contracting with its associated fiduciary responsibilities.

READY FOR THE NEXT STEP?

This guide has been prepared by the Montana Innovation Partnership (MTIP) powered by MSU TechLink Center. A program of the Montana Department of Commerce, MTIP provides free coaching to Montana technology-based companies seeking help in applying to federal and state R&D and commercialization funding programs. For more information, contact the MTIP Program Manager at techlinksbir@montana.edu or visit MTIP's website at montanainnovationpartnership.org.

