

Direct or Indirect, but Not Both

Written by Nick Sanders
Friday, 05 February 2016 00:00

The most important concept in the Federal Cost Accounting Standards (CAS) is consistency. Do what you say you are going to do, and do it that way every single time. It's a deceptively simple concept and violated more often than one might think. Simple to articulate, difficult to apply.

Case in point: Standard 402: "Consistency in Allocating Costs Incurred for the Same Purpose." The fundamental requirement of CAS 402 is as follows:

All costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only with respect to final cost objectives. No final cost objective shall have allocated to it as an indirect cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included as a direct cost of that or any other final cost objective. Further, no final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included in any indirect cost pool to be allocated to that or any other final cost objective.

And there you go. Costs must be either direct or indirect costs and, once a contractor determines which of its costs are direct and which are indirect, then all of those costs incurred for the same purpose, in similar circumstances, must be treated the same way—either direct or indirect. The contractor must be consistent in its cost accounting treatment, and the only loophole is that you can treat costs differently if the purpose and/or circumstances are different. Otherwise: consistency is the watchword.

The DCAA Contract Audit Manual contains several illustrations to help auditors distinguish cost accounting practices that are compliant with CAS 402 requirements from cost accounting practices that are not compliant. Here's one that caught our eyes—

Problem. A contractor has a Government contract which requires extra effort for planning and cost management. It hired extra people to accomplish this effort and accounted for all their labor cost as a direct charge to the contract. The contractor has other people performing the same functions for more than one contract and their labor is charged to indirect costs.

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Solution. Since the work being performed is the same and the only difference is in the amount of effort required to accomplish the function, this practice would not comply with the standard. The contractor could correct the situation by:

(1) charging all of these costs to indirect costs and developing an equitable distribution base or

(2) direct charging all of these costs.

We've encountered many upon many unintentional violations of CAS 402; some were trivial in amount (and consequences) and others not so much. Recently, government contractor Centerra Services International Inc., formerly known as Wackenhut Services LLC, seemingly ran afoul of CAS 402 and, as a result, had [to pay \\$7.4 million](#) to settle the resulting False Claims Act litigation.

According to the Department of Justice announcement—

Wackenhut provided U.S. military bases with firefighting and fire protection services under a subcontract with Kellogg Brown & Root Inc. (KBR), the prime contractor for the Army's contract for logistical support in the military theater, known as LOGCAP III. LOGCAP III is the third generation of contracts under the Army's Logistical Civil Augmentation Program. The government alleged that from 2008 to 2010, Wackenhut inflated its labor costs by billing the salaries of certain managers as direct costs under the subcontract, when those salaries had already been charged as indirect costs. The government further alleged that Wackenhut artificially inflated its labor rate by counting its costs for holidays, vacation, sick leave, rest and recuperation and other variable labor costs twice in calculating the rate. Wackenhut billed KBR, which then passed on the costs to the government under LOGCAP III.

While we don't know any of the specifics of the allegations, it appears that Wackenhut (or Centerra Services, as the company is now called) decided to bill the labor associated with "certain managers" as direct costs, even though the salaries of those managers had been budgeted as indirect costs and included in the approved contract provisional billing rates as indirect costs. CAS 402 says you can't do that. If you budget your managers' salaries as indirect costs you have to treat those salaries as indirect costs on a consistent basis—even if

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“certain managers” supported the LOGCAP efforts on a full-time basis.

This CAS-based logic may seem counter-intuitive to some people. They might tend to think that if a cost *can* be identified to a project or contract (or “final cost objective” in CAS lingo) then it should be—or *must* be—a direct cost of that project or contract. But CAS says otherwise: CAS 402 says that if you identified that cost as an indirect cost, then it must always be treated as an indirect cost, even if it might be easy to treat it as a direct cost. As we noted, the only exception would be for a different purpose or different circumstances.

Indeed, if you were to go look at the very definition of “direct cost” in the FAR or in the CAS regulations, you would see that a direct cost is one that *has been* identified as a direct cost within the contractor’s accounting system—not one that *could* be identified as a direct cost. The distinction between those two concepts is crucial to CAS compliance.

The decision to make certain costs—or certain functions or activities—direct costs only or indirect costs only needs to be made with a lot of discussion and forethought, because once that decision is made it is very difficult to change. Typically, contentious discussions arise with respect to Security, Contracts, and similar functions. If the contractor states that Security is always an indirect function then, absent a different purpose or different circumstances, it must remain an indirect function—even if a Security person is assigned to an individual contract on a full-time basis.

CAS 402 means that if you decide that the cost of all personal computers is an indirect cost, then you cannot charge the cost of certain personal computers as a direct contract cost, even if you wouldn’t have purchased them absent the contract’s need for them.

CAS 402 means that if you decide that the salary costs of managers is an indirect cost, then you cannot charge the cost of certain managers as a direct contract cost if they are incurred in like circumstances. Because if you do so, you are violating the requirements of CAS 402 and you may find yourself in the midst of expensive False Claim Act litigation as a result.

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