Part 1 of this series can be found **here** . We discussed why this is an important—nay, *critical* —topic for you, worthy of an investment of your time and expense.

Part 2 of this series can be found **here** . We discussed why you need input from a diverse group of stakeholders. You will want to solicit input from a number of diverse perspectives because your cost allocation decisions—including your decision regarding the emphasis you place on maximizing the amount of direct charges—can affect your corporate culture in perhaps unexpected ways.

Part 3 of this series can be found **here** . We discussed the importance of making sure the entity's organization structure reflected how the entity was being managed. We also discussed the notion that precision is not a synonym for accuracy; and that the benefit of precise cost allocations is often not worth the price to be paid, in terms of additional administrative burdens and risks of noncompliance.

In today's article we want to explore further the organization structure, albeit at a higher level than before. We want to discuss segmentation, as well as special types of organizational structures.

Before we get too deep into the subject at hand, we need to define some terms, using the definitions found in the Federal Cost Accounting Standards (CAS). You may not be subject to CAS coverage, but you should still know CAS—if only because most DCAA auditors will use CAS allocation standards as the "best practices" standard for evaluating your cost allocation practices. Plus, you will want to speak the auditors' language, using appropriate terminology, when you support audits; that is its own "best practice" right there.

One can easily get confused about the CAS terminology applicable to organization structures. Some terms you need to know are:

Home Office – A Home Office is an office responsible for directing or managing two or more but not necessarily all segments of an organization. It typically establishes policy for, and provides guidance to, the segments in their operations. It usually performs management, supervisory, or administrative functions, and may also perform service functions in support of the operations of the various segments. An organization which has intermediate levels, such as groups or divisions or sectors, may have several home offices which report to a common “headquarters” or “corporate” home office. (See CAS 403, Definitions.)

Intermediate Home Office – A Home Office located at an intermediate level, such as Group, Division, or Sector. An Intermediate Home Office may be both a segment and a Home Office. (For example, it can be a segment of the Corporate Home Office for purposes of receiving Corporate allocations, and a Home Office with respect to allocating costs to the segments it manages.) (See CAS 403, Definitions.)

Segment – A Segment means one or two or more, divisions, product departments, plants, or other subdivisions of an organization reporting directly to a Home Office, usually identified with responsibility for profit and/or producing a product or service. The term includes Government-owned, contractor-operated (GOCO) facilities, and joint ventures and subsidiaries (domestic and foreign) in which the organization has a majority ownership (or control). (See CAS 403, Definitions.)

Business Unit – A Business Unit is any segment of the organization, or an entire business organization which is not divided into segments. (See CAS 410, Definitions.)

(You may note that the definitions for “segment” and “business unit” are remarkably similar. For purposes of this article, when we discuss allocations of centralized payments and service functions, and centralized management, from a home office, we will use the term “segment”. When we discuss allocations of segment management and other segment expenses to contracts/projects, we will use the term “business unit”.)

The first thing you’ve got to do is to identify your segments and home offices. This may be quite easy to do; then again, it may be painful and involve loud voices and fingerpointing. As is the case with so many cost allocation issues, the correct answer goes to the heart of your entity’s business strategy. First of all, note that the CAS definition does not align precisely with the requirements of SFAS 131 (ASC 280) or with the requirements of IFRS 8—both of which are concerned with information reviewed by the Chief Operating Decision Maker (CODM). Instead, CAS focuses on where the entity determines profit/loss “and/or” produces a single product/provides a single service. Consequently, your reportable segments for government contract cost accounting may differ significantly from your reportable segments for financial reporting purposes.

But in that difference lies freedom. For government contract cost accounting, you have the freedom to define your segments in manner that promotes compliance with applicable regulations. To state it another way, you have the freedom to reduce your risk of noncompliance by smartly structuring your segments. For example, you can structure your segments to keep your commercial operations the hell away from your government operations, so as to let your commercial operations do what they need to do in the way that works for them, while locking down your government operations so as to keep the government auditors happy.

And that's the first choice: do you separate your government and commercial operations, or integrate them. Keep them separate, and you are largely deciding to have two separate infrastructures; integrate them, and you can find process efficiencies and cost savings.

In our view, the problem with separating the two types of operations is that—sooner or later—the commercial side is going to want to bid on a government or quasi-government job, or the government side is going to want to borrow labor from the commercial side. At that moment, the Berlin Wall you have carefully built and maintained will start to crumble, and now your commercial side is subject to those pesky and burdensome government rules. So if you suspect that will be the long-term result, you may as well go all-in now and just admit you're a government contractor.

On the more positive side, having separate segments permits each segment to have its own unique cost accounting practices. You can also parse out CAS coverage by segment, with one (or more) segments being fully CAS-covered, while others are subject to Modified coverage or perhaps exempt from CAS altogether. This situation, if properly handled, can reduce your risk of CAS noncompliance and permit you to tailor your cost accounting practices to the needs of your operations.

However, you should also keep in mind that the more segments you have, the more Inter-Organizational Transfers you will also have. IOTs are difficult to account for, as we **have discussed** more than once on this site. As in many aspects of cost allocations, the more complexity you have, the more administrative burden you create—and the more your risk of noncompliance increases. It is important to strike the proper cost/benefit balance.

Remember, you do not need government approval for your organization structure and your definitions of your segments and home offices. This will be your management and cost allocation structure. Do not let government employees—especially DCAA auditors—substitute their judgment for yours. Your job is to comply with applicable regulations (including CAS where applicable), and once you've met that burden then you are good to go. We've seen far too many junior auditors try to opine on the propriety of contractors' cost accounting structures (without any reasonable basis for doing so); and we've seen too many contractors cave in to those auditors' comments without challenging them on the missing regulatory basis.

Some aspects of your organization structure can qualify for special cost treatment. Perhaps surprisingly, the DCAA Contract Audit Manual (CAM) permits flexibility in certain circumstances.

The first type of organization structure that can qualify for special treatment is a "special facility," as that term is defined by the DCAA CAM at 7-300. Actually, to call the discussion a "definition" may be overstating the case. The CAM states—

Facilities to which this guidance is applicable cannot be specifically designated by name or type but rather must be determined by whether or not they meet certain basic criteria. The first criterion to be met is that the costs involved in the operation of each facility must be significant in amount with respect to the contractor's overall operations. The second criterion is that the facility benefits only a limited portion of the contractor's total workload. Wind tunnels and space chambers are representative of facilities which, if they meet the criteria above, would be subject to the guidance provided in this section.

For those "special facilities" discussed in the foregoing paragraph, as well as for certain Microelectronic Center (MEC) facility costs, the CAM permits three methods of allocating the facility costs to the benefiting work. Importantly, the CAM states that the requirements of CAS 418 do not apply to "special facilities" so you may be free to be creative—so to speak—in your cost allocation methodology. (But read the CAM first!)

Another type of organization structure that can qualify for special treatment is a "special business unit" (SBU). This is DCAA's term to de scribe a contractor subsidiary, division, or other form of business organization that is established to accomplish certain specific tasks or to gain a competitive advantage. The DCAA CAM states that a SBU "is not a distinct entity form," and "therefore, the accounting for an SBU should follow the principles established for the actual entity involved and be consistent with the contractor's disclosed accounting practices."

Again, the term (and associated audit guidance) is somewhat ambiguous and it can encompass several different “flavors” of organization structure, including joint ventures and teaming arrangements. The CAM states (at 7-1804)—

An SBU is a segment of the establishing contractor since the SBU is either a subdi vision of that contractor or is controlled by that contractor.

(1) Some SBUs have employees hired and paid by the SBU who actually perform the required contract effort. These SBUs may also have their own assets and liabilities and have profit and loss responsibility. They are usually reportable segments for financial and tax purposes. These SBUs are often engaged in foreign military sales or direct commercial sales to foreign governments. These SBUs are usually formed to limit tax and /or legal liability.

(2) Other SBUs are more like joint ventures and teaming arrangements. These busi ness organizations have no employees and subcontract virtually all (over 90 percent) con tract effort to other contractor division s and/or outside subcontractor(s). Often these SBUs have little or no assets. This type of SBU may have been formed to gain competitive, cost, and/or technical advantages.

The guidance to auditors continues—

Basically, there are two types of cost advantages that SBUs can attain. The first type results from the fact that an SBU is a specialized contracting entity supported by one or more established contractor entities. The second type results from cost alloca tion practices that enable an SBU contract to significantly reduce, or altogether avoid, the amount of material overhead and G&A that the contractor would normally have to allocate to its subcontracts and/or interdivisional work. [However] f the cost allocation practices cause a significantly different allocation to a SBU contract than would have been allo cated to the same contract if issued directly to the contractor's operating segment, the cost allocation practices may be inequitable and/or CAS noncompliant.

The DCAA CAM has several pages discussing cost allocation issues associated with SBUs. If you think you want to try to set up an SBU, you would be well advised to review the discussion.

To sum up, when you establish your organization structure you will identify your segments and the home offices to which they report. Segmentation is an important decision, with implications for mitigating risk of noncompliance as well as implications on the amount of administrative work you will be incurring. Not all segments are created equal: in some circumstances you can establish special cost allocation practices and use the DCAA CAM to justify why they are compliant.

If you've come this far, you've done most of the work. You've created a logical organization structure and made some key decisions about how your cost allocations are going to work. The rest of the job includes choosing logical indirect cost pools and appropriate allocation bases. But the standard pool and base methodology may not be appropriate in all circumstances. There may be some outlier-type segments, business units, and/or contracts that are so different from everything else that they require special handling.

Accordingly, the next installment of this series will discuss the little understood phenomenon of "special allocations."