Revisions in the Audits of Federal Government Contractors: Certified Public Accountant
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The new audit and accounting guide is applicable to 1991 audits

Revisions in the *Audits of Federal Government Contractors*

By Robert A. Esernio, Jr., Robert A. Dyson and Harriet Coorssen

The rules and regulations applying to government contracts seem like a giant maze to the newcomer to this work. The new AICPA guide captures the essence of the required knowledge needed by a CPA in this work and provides references to more detailed instructions.

In 1990, the AICPA issued an audit and accounting guide, *Audits of Federal Government Contractors*. The guide replaced the industry audit guide, *Audits of Government Contractors*, which was originally issued in 1975 and subsequently enhanced in 1981 by SOP 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts." The guide applies to audits of financial statements of entities providing goods and services to the federal government or their subcontractors. It reflects changes resulting from the accounting and auditing pronouncements and federal statutes and regulations issued since 1975.

The objectives of the guide are to provide both a general background of the federal government contracts environment and practical guidance regarding accounting, auditing, and financial reporting for federal contractors. It describes relevant federal regulations and associated business and operating risks and describes the prevalent practices in applying professional accounting and auditing pronouncements and SEC regulations to government contractors. And if more information is needed, the guide contains an annotated bibliography of selected books, periodicals, and manuals useful in obtaining additional understanding of government contracting, keeping abreast of current developments, and researching specific issues.

The federal contract sector has become more complex with the passage of new laws and regulations. The guide reflects that growing complexity by providing a more complete description of Federal Acquisitions Regulations (FAR) that include FAR supplements, Cost Accounting Standards Board pronouncements (CAS), cost principles, definitions of cost allowability, changes in cost accounting practices, and cost estimation. In addition, the guide discusses supplemental acquisition regulations issued by various government agencies and circulars issued by the Office of Management and Budget which supplement and implement FAR. Finally, the guide describes defective pricing, contract claims, terminations, and suspension and debarment. The guide, however, presents only a general description of these matters and practitioners and industry accountants are advised to refer directly to FAR and other publications listed in the guide's bibliography in order to keep current or to research specific situations.

USING THE GUIDE

The guide is a mini-course in contracting with the federal government. It explains what it means to do business with one of the world's largest purchasers of goods and services. The guide alerts the CPA to the unique circumstances present when a business entity decides to contract with a sovereign power that "conducts its procurement activities under specific laws and implementing regulations."

Chapter 1, "Contract Procurement Process," provides general background on how the federal government contracts for goods and services. Some it buys off the shelf, just as many other customers. Frequently, however, the federal government will be the only purchaser and there will be no market to establish prices or foster competition. Accordingly, the federal government must introduce procedures to insurequality at a reasonable price. The auditor must understand these procedures.

Chapter 2, "Federal Acquisition Legislation and Regulations," provides the background for the auditor to understand the laws and regulations that must be considered in designing the audit of a federal contractor. It explains the role of FARs and the cost principles that must be followed in accounting for federal government contracts. The auditor is made aware of the fact that there are differences between GAAP and FAR and CAS requirements.

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FINANCIAL REPORTING CONSIDERATIONS

Chapter 3 of the guide presents accounting and financial reporting matters pertaining to federal contracts. Although generally updating the previous guide to incorporate recent FASB pronouncements, the guide does present additional guidance on matters unique to the federal contract area regarding accounting changes, certain research and development expenditures, program accounting, contingencies, disclosures, and cash flow statements.

Accounting Changes

The guide provides two methods of applying APBO 20, "Accounting Changes," to federal contractors. The first concerns a change in method of accounting from completed contract to percentage of completion, or vice versa. According to the guide, this change requires the retroactive application of the new accounting principle by restating prior period financial statements in accordance with APBO 20, paragraph 27.

the contractor and government agree to share the estimated costs and anticipated benefits of certain research and development activities.

The second concerns changes in the application of an accounting policy, such as the basis of measuring progress in the percentage of completion method from "cost to cost" to "units of delivery," that is accounted for as a change in accounting principles in accordance with APBO 20, paragraphs 19 to 22. Under this method, financial statements for prior periods included for comparative purposes would be presented as previously reported and the cumulative effect of changing to the new accounting principle would be included in net income of the period of the change.

Fixed-Price Best-Efforts R&D Cost Sharing Arrangements

The guide provides guidance on accounting for and disclosing arrangements where the contractor and government agree to share the estimated costs and anticipated benefits of certain research and development (R&D) activities. In particular, the guide sets forth the conditions under which certain activities qualify as other than R&D contracts. In these arrangements, the contractor is obligated to perform on a best efforts basis to achieve agreed upon objectives in return for partial reimbursement of costs and sharing the rights of the R&D results with the government. In general, the government is expected to be the sole or principal customer of any products developed as a result of these arrangements.

Program Accounting

Program accounting concerns the deferral of certain project costs, ordinarily recognized as period expenses, in anticipation of potential revenues from future new or expanded contracts. The guide does not consider program accounting appropriate in accounting for government contracts and subcontracts except in very limited applications, such as major commercial aircraft production, which is sold to both commercial and governmental customers.

Contingencies

The guide emphasizes that contingencies should be disclosed, when appropriate, in accordance with SFAS 5, and provides several examples of situations and types of information requiring disclosure. These situations include unusual or infrequent contract price adjustments, provisions for loss, substantial incentive income, significant claims revenues, and significant problems encountered in the performance of contracts materially affecting operations. For example, the guide requires expensing costs in excess of the level permitted by the contract, unless the facts and circumstances require the classification of these costs as assets. In addition, the guide notes that the government is claiming rights to excess plan assets of terminated, overfunded pension plans when earlier government reimbursements funded or partially funded the plan.

Financial Statement Disclosures

The guide presents reporting and disclosure practices unique to federal contractors while, at the same time, noting that financial statement reporting and disclosure requirements of federal contractors generally do not differ from the requirements for other business enterprises.

Pertaining to the recognition of contract revenue, the guide requires the disclosure of the methods of measuring the extent of progress toward completion when the percentage of completion method is applied or the specific criteria used to determine when a contract is substantially complete when the completed contract method is applied.

. . . interest capitalization is not necessary if the contract costs are billed and collected currently.

The guide also discusses the requirement that information about the contractor's major customers be disclosed. SFAS 30, "Disclosure of Information about Major Customers," requires public companies to disclose the fact that 10% or more of its revenue is derived from sales to any single customer and the amount of revenue from each such customer. In applying this rule to federal contractors, the guide considers the federal government as one customer.

Interest Capitalization

The guide supports the predominant practice among federal contractors of not capitalizing interest when applying the percentage of completion method on long-term government contracts. It reasons that the manufacture of the products under the contract are employed in the earnings process and, therefore, under SFAS 34, need not include capitalized interest. In addition, interest capitalization may not be necessary if the contract costs are billed and collected currently.

Cash Flow Statements

The guide indicates that federal contractors should present the form and content of the statement of cash flows in a manner similar to other business enterprises, with some differences reflecting the federal contract environment. Progress and advance payments received on contracts should be reported at gross, regardless of whether those payments have been applied against unbilled contract receivables or accumulated costs of contracts in progress in the balance sheet. Contractors using the direct method in reporting cash flows should

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present progress and advance payments received on contracts, if significant, as a separate class of cash receipts from operating activities. Those using the indirect method should show progress and advance payments, if significant, as a separate adjustment in reconciling net income to cash provided for operating activities. Contractors accounting for progress and advance payments as borrowings should report such amounts as cash received from financing activities.

Other Matters

The guide also provides new guidance on the following:

■ *Contract Incentives.* It requires a reasonable estimate of revenue resulting from contract incentives to be included in total estimated revenues when applying the percentage of completion method. If a contractor cannot reasonably predict whether performance targets will be met, then such revenue should be excluded from total estimated revenues.

■ *Contract Cost Estimates.* It notes that estimating total contract costs is a complex process requiring the participation of financial, engineering, manufacturing, and other technical departments. Contract cost estimates change due to contract modifications, productivity gains, unanticipated technical problems, and additional information. Because of these changes, contract cost estimates should be reviewed and updated regularly over the period of contract performance. The effects of changes in estimates should be accounted for by using the "cumulative catch-up" method, in which the entire revision is recognized in the period of change. As a result, the balance sheet at the end of the period that the change occurred should reflect the accounting information as if the revised estimate had been applied since the beginning of the contract period.

■ *Other Contracts, Arrangements, and Related Accounting Considerations.* As a general rule, revenues and costs should include all items for which the contractor has an associated risk, including materials and equipment either furnished by the government or that which the contractor is required to purchase as an agent of the government. The guide recommends excluding these material and equipment costs or subcontract costs from sales and cost of sales, even those included in the contract price, if they represent such a substantial amount in relation to the contractor's other performance costs that their inclusion might significantly distort the contractor's volume of activity. Excluded costs should be reported in a manner consistent with the terms of the contract. If such costs are excluded from sales and cost of sales, the general nature of the related transactions, if material, and the accounting policy applied to them, should be disclosed in the notes to the financial statements.

■ ***Inventories and Partial Payments.*** The predominant practice among federal contractors provides that progress payments received on fixed-price contracts are usually applied first to amounts carried in unbilled receivables, with any remainder applied to accumulated costs of contracts in progress (inventories).

. . . the guide does highlight those matters unique to the federal contract environment.

This is based on the view that legal title to the related inventories vests with the government on the contractor's receipt of progress payments. However, some contractors believe that the standard progress payment clause entitles the government only to a lien or secured interest in the related inventory and therefore should be accounted for as a financing transaction.

AUDITING CONSIDERATIONS

Chapter 4 provides guidance to independent auditors in performing audits of financial statements of federal contractors. The guide presents considerations necessary in performing an audit of a federal contractor, including those applicable to any audit performed in accordance with GAAS, while emphasizing matters unique to the federal contract environment. A discussion of those matters unique to the federal contract environment, particularly those pertaining to planning and applying SAS 55, "Consideration of Internal Control Structure in a Financial Statement Audit," follows.

Planning

SAS 22, "Planning and Supervision," requires the auditor to consider matters relating to the contractor's industry and business in planning the audit. The guide presents the following characteristics of the federal contract industry:

■ Cost-based pricing, which provides for reimbursement of allowable costs;

■ Reliable payment of appropriate billing;

■ Financing in the form of advance payments and progress billings;

■ Government audit and other oversight of the contractor's operations that often provide recommendations for avoiding costs. Audits by government agencies may result in disputes over allowable costs whose resolution is sometimes delayed. The resulting uncertainty of recovering disputed costs should be addressed in the audit and be accounted for in accordance with SFAS 5;

■ Risk of allegations of defective pricing if the contractor fails to submit current, accurate, and complete costs or pricing data, or cost mischarging leading to loss of contracts, suspension and disbarment, loss of reputation, or criminal penalties assessed against both the contractor and management. This includes both the intentional and unintentional improper allocation of costs between individual and different types of contracts;

■ Risk of disallowance of incurred costs that result in reduced revenues;

■ Risk of cash flow deficiencies if progress payments are withheld by the government or retentions are increased because of disputes with the government, noncompliance with regulations, or other problems;

■ Risk of contract losses if the contractor is unable to meet its contractual obligations regarding the design or manufacture of complex or state-of-the-art products.

■ Risk of unrealizable investments in equipment and facilities and a general reduction in business activity resulting from changes in government programs and funding policies, as opposed to general economic conditions;

■ Risks relating to excess or obsolete stock are usually less than other commercial enterprises experiences; and

■ Risk of unilateral contract changes or claims affecting revenues.

The guide also presents the following additional matters to be considered by

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the auditor when obtaining an understanding of the federal contractor's business:

■ The contractor's products and services, including the relationship of those products and services to major federal procurement programs;

■ The mix of government and commercial business;

■ The government agencies representing the contractor's customers;

■ The methods of obtaining contracts;

■ The types of contracts, i.e., firm fixed-price, fixed-price incentive, and cost-plus-fixed-fee;

■ The key information on significant contracts, including the government agency or department administering the contract; the type of contract; contract price; revenues, costs, and profit/loss recognized to date; estimated revenues, costs, and profit/loss at completion; and incentive, escalation, or other relevant contract provisions;

■ The significant government regulations governing contract accounting, such as FAR, FAR supplements, and CAS;

■ The contractor's contract backlog;

■ The Cost Accounting Standards Board Disclosure Statement and revisions; and

■ The litigation, claims, and disputes with the government.

Consideration of the Internal Control Structure

In planning the audit, the auditor should obtain a sufficient understanding of each of the three elements of a contractor's internal control structure. These elements are the control environment, the accounting system, and the control procedures. The control environment reflects the overall attitude, awareness, and actions of the board of directors, management, owners, and others concerning the importance of control and its emphasis in the entity. The accounting system consists of the methods and records established to identify, classify, and report an entity's transactions and to maintain accountability for an entity's assets and liabilities. Control procedures are those policies and procedures in addition to the control environment and accounting system that are established to provide reasonable assurance that specific objectives are achieved.

After obtaining an understanding of the internal control structure, the auditor assesses control and inherent risk and determines detection risk. The guide adopts the standard definitions of these risks, as follows:

■ ***Control Risk.*** The risk that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by the contractor's internal control structure policies and procedures.

■ ***Inherent Risk.*** The susceptibility of an assertion to material misstatement assuming there are no related internal control structure policies and procedures.

■ ***Detection Risk.*** The risk that the auditor will not detect a material misstatement that exists in an assertion.

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The guide applies SAS 55 in a manner consistent with its application to a commercial enterprise. The auditor assesses control risk in terms of financial statement assertions by evaluating the effectiveness of the internal control structure in preventing or detecting material misstatements in the financial statements.

Failure to identify changes and segregate related costs exposes the contractor to delay and not recovering costs.

Based on the assessed level of control risk and inherent risk, the auditor determines the acceptable level of detection risk, which is then used to determine the nature, timing, and extent of the auditing procedures to be used to detect material misstatements in the financial statements. Although this approach is fairly consistent with a commercial enterprise, the guide does highlight those matters unique to the federal contract environment.

All of the considerations discussed hereinafter address the risk of material misstatement of financial reporting. The need for proper reporting is enhanced by risks inherent to the federal contract environment, such as those related to allegations of defective pricing due to the failure to submit current, accurate, and complete data; cost mischarging resulting in the disallowance of incurred costs; and cash flow deficiencies resulting from disputes with the government or noncompliance with regulations.

Consideration of the Control Environment

As in all entities, the management of a federal contractor is responsible for maintaining an effective internal control structure. However, two elements of the control environment, management's philosophy and operating style and external influences over the contractor, contain considerations unique to federal contractors. Management's philosophy and operating style concern its approach to taking and monitoring business risks, its attitudes and actions towards financial reporting and its emphasis on meeting financial operating goals. Management's commitment to maintaining an effective internal control structure is a significant factor in obtaining assurance that controls operate effectively and that errors and irregularities material to the financial statements are prevented, or, at a minimum, detected and corrected on a timely basis. The size of many federal contracts and complexity of applicable federal regulations make the establishment of an adequate internal control structure imperative to avoid disputes and other risks related to pricing and compliance. A second factor concerns external influences over the contractor, such as the regulations and government oversight inherent to the federal contract environment. The regulations and oversight increase the probability that improper reporting will be detected either by the independent auditors or government oversight personnel.

Consideration of the Accounting System and Control Procedures

In considering the accounting system and control procedures, the auditor should address the following, which the guide considers to be particularly important elements of a federal contractor's internal control structure.

Monitor Compliance with Government Procurement Regulations. The system should provide reasonable assurance that the contractor is complying with applicable regulations and provide the ability to identify and respond to changes in those regulations. All federal contractors are required to comply with FAR and certain FAR supplements, which include a detailed set of cost principles. In addition, contractors with substantial business with the government are generally required to comply with CAS. Contractors not required to comply with those standards may use CAS as nonauthoritative guidance in cost accounting matters.

Estimating Systems and Proposal Preparation Practices. Failure to maintain adequate controls over developing cost estimates used in contract proposals exposes management to the risk of incurring losses on contracts if the proposed costs are estimated too low. The contractor should have a system in place that produces these estimates and identifies the sources of factual information used to develop such estimates and assures that these sources are approved by management.

Contract Cost Accounting Practices. The information on contract-cost records is used for such functions as controlling costs, evaluating the status and profitability of individual contracts, and preparing customer billings. These records also provide information used in the periodic detailed cost reports submitted to management and federal and contractor project managers. In addition to the risks associated with improper financial reporting discussed above, these controls also provide assurance that all allowable costs are billed, thereby reducing the risk that the contractor does not recover all allowable contract costs.

Contract-Revenue Recognition Practices. Contract revenues are generally related to the applicable contractual terms. This is particularly true of cost-reimbursement contracts. As a result of this relationship between costs and revenues, these controls should be related to those pertaining to contract costs and compliance with government regulations, such as the cost principles outlined in FAR and CAS.

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Billing Procedures. The federal contractor should maintain adequate controls that provide assurance that the method of billing is in accordance with the specific contract terms and is reviewed and approved by an appropriate level of management. This is achieved by providing personnel responsible for billing with adequate training in applicable regulations, such as CAS and FAR part 32, "Contract Financing," which presents the record-keeping and reporting requirements pertaining to advance and progress payments. In addition, the controls should provide assurance that personnel responsible for billing receive timely and accurate billing-related information, as discussed under contract cost and revenue recognition practices.

Change Order Identification, Pricing, and Reporting. Federal contractors should have adequate controls to identify, negotiate, and process various

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change orders so to address the frequency of change orders and the strict regulations governing price adjustments. Although the government acknowledges both the change and the price adjustment in instances of formal change orders, such acknowledgement does not always accompany less formal changes, which are called constructive change orders. Failure to identify constructive changes and segregate the related costs exposes the contractor to the risks of incurring delay and disruption costs and not recovering costs incurred in performing the additional work.

Claims Processing and Reporting. Claims may arise from disputes, such as those over change orders or constructive change orders, and may have an effect on the ultimate profitability of a contract. Therefore, a federal contractor should have adequate controls that provide reasonable assurance that potential claims are identified on a timely basis, related costs are documented and segregated, and the government is notified of the claims in a timely fashion.

Inventory Costing and Control. Ordinarily, the contractor need not implement additional controls on inventory as government inventory poses no special risks. Indeed, the risk of inventory obsolescence related to federal contracts is less than that in ordinary commercial contracts as the nature of most government contracts results in the recovery of allowable costs. However, appropriate controls should be maintained if the contractor uses a borrow/payback system, in which inventory is transferred between contracts, in order to obtain assurance that inventory is transferred with the appropriate government approvals and contracts are properly charged in the transfer.

Government-Furnished Property. The contractor should have adequate controls designed to safeguard government-furnished assets and to avoid charging this property to contracts and including it in the contractor's assets for financial reporting purposes.

Cost Aspects of Related Party and Inter-Organizational Transfers. In general, the purpose of controls over these transfers should ensure their proper recording, which is ordinarily based on cost for both government contracting and financial reporting purposes. The controls, however, should address the limited exceptions permitted by FAR.

Illegal Acts. Auditors should be aware that federal contractors may be subject to more laws and regulations than other commercial clients when applying SAS 54, "Illegal Acts by Client." For example, contractors are subject to FAR, CAS, and other laws specifically addressed in the contract.

Substantive Tests

In addition to the guidance pertaining to planning and internal control structure matters discussed above, the guide provides detailed guidance on significant substantive tests that the auditor should consider applying in audits of federal contractors. These procedures pertain to:

- Contracts in process;
- Accounts receivable;
- Progress payments;
- Property and equipment;
- Contract-related liabilities;
- Government claims;
- CAS Disclosure Statement;
- Independent research and development and bid and proposal costs; and
- Classified contracts.

CPAs are advised to refer to the guide when considering these matters in performing an audit of a federal contractor.

EFFECTIVE DATES

The guide has different effective dates for its accounting and financial reporting provisions and auditing provisions. It effectively "grandfathers in" the accounting for existing contracts by applying the accounting and financial reporting provisions to contracts entered into after December 31, 1990. Its auditing provisions are effective for audits of financial statements of periods beginning on or after December 15, 1990. Earlier application of all provisions is encouraged.

THE GUIDE AS REFERENCE TOOL

The guide fulfills the function of a reference guide in that it directs practitioners and accountants to various professional pronouncements, government laws and regulations, and other publications useful in addressing and researching specific situations. The guide also presents accounting, financial reporting and auditing guidance in addressing the unique environment of government contracting. Ω

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