



In This Issue

- [Introduction](#)
- [Overview of the USG Contracting Market](#)
- [Compliance Risks and Considerations for USG Contractors](#)
- [Conclusion](#)
- [Contacts](#)

Accounting and Compliance Considerations for U.S. Government Contractors

This is one of a series of aerospace and defense (A&D) industry spotlights. This series focuses on key accounting and operational matters relevant to companies within the A&D industry.

Introduction

Many commercial companies and traditional U.S. government (USG) contractors are looking for ways to gain market share in the growing aerospace industry. From satellite development to rocket launch services, there are several ways that companies can get involved in the supply chain. However, truly commercial companies that are looking to enter the USG aerospace industry or to expand into larger public sector contracting opportunities should be aware of unique risks and challenges related to working with the USG; failure to comply with government contract compliance regulations can result in the inability to bid on government contracts, the withholding of payments, and penalties. This spotlight explores some of the risks and cost accounting considerations that companies should think about before bidding on or entering into a USG contract.

Overview of the USG Contracting Market

Acquiring and performing under USG contracts can be complicated processes. The USG's acquisition rules, as embodied in the [Federal Acquisition Regulation \(FAR\)](#), as well as supplemental rules published by many USG agencies and departments, are vast and ever-changing. The USG procures a broad variety of goods and services from the private sector, including everything from paper supplies to satellites. Since the nature of the products and services varies so widely, the type of procurement used, and even the method of soliciting contracts, will also vary.

At a high level, the USG buys products and services in two basic ways: (1) price-based contracting and (2) cost-based contracting. Both methods are described below.

Price-Based Contracting

In price-based contracting, the USG relies on competition or the marketplace to establish a "reasonable price" and typically pays a fixed price for the product or service regardless of the contractor's actual costs. For example, when the USG buys an item sold in the commercial marketplace (such as paper), it accepts that the established price has been subject to an arm's-length determination (i.e., supply and demand). In such cases, the USG is interested only in obtaining the best price — quality and quantity considered — rather than in assessing the contractor's manufacturing costs and profit included in the selling price or determining whether the contractor's costs are consistent with federal procurement regulations. Therefore, the USG is willing to pay as much for commercial products and commercial services as any other buyer in the marketplace. The main advantage of the price-based contracting method is that it provides certainty for both the contractor and the USG since the risk of cost overruns is primarily borne by the contractor. The USG has been aggressively using commerciality and "other transaction agreements," which come with fewer compliance requirements than traditional noncommercial USG contracts, to procure rocket launch services from commercial companies.

Federal contract regulations, starting with the Federal Acquisition Streamlining Act of 1994, have indicated a preference for commercial item procurement, and the recently issued [U.S. Space Force Commercial Space Strategy](#) guides "the integration of commercial space solutions." However, some of the products and services needed by the USG are not currently sold in the commercial marketplace or there is no adequate competition for them. In these cases, FAR 15.402¹ requires contracting officers to either (1) obtain cost or pricing data to establish that prices offered are fair and reasonable or (2) require cost-reimbursable contracting.

Cost-Based Contracting

In cost-based contracting, the contractor's cost data become the basis for the USG's establishment of contract value. This reliance on cost data results in more extensive regulations and oversight, including audits, to ensure that costs are reasonable as established by regulations such as the FAR or [Cost Accounting Standards \(CAS\)](#). Under cost-based contracting, (1) the USG may reimburse a contractor on a fixed-price basis or (2) in cases in which the product or scope of work is not well defined (e.g., developmental items), reimbursement can be based on allowable costs incurred, plus a fee. The key advantage of cost-reimbursable contracting is that it provides flexibility for the contractor since the USG shares the risk of cost overruns.

Compliance Risks and Considerations for USG Contractors

There are various compliance risks and considerations related to both price-based contracting and cost-based contracting. Contractors must (1) understand how the USG intends to buy aerospace products and services and (2) consider the risks and requirements that come with each procurement method.

¹ FAR Part 15, "Contracting by Negotiation."

Compliance Risks and Considerations Related to Price-Based USG Contracting

While less onerous than cost-based USG contracting, price-based USG contracting still has a few compliance risks to consider:

- *Commercial item classification and documentation* — Contractors need to understand the criteria used to classify a product or service as commercial and maintain detailed documentation to demonstrate and defend that their product or service meets the commercial product or commercial service definition. The [Department of Defense Guidebook for Acquiring Commercial Items](#) provides guidance on determining whether a product or service qualifies as a commercial product or commercial service. Failure to receive a positive commercial item determination for products or services offered can affect the bidding process, the type of contract awarded, or the level of oversight and reporting required.
- *Pricing strategy* — The length of USG contracts can vary widely. If long-term USG contracts include prices that are based on current economic conditions, there is risk that such prices may not reflect future economic conditions. For example, long-term price-based USG contracts awarded in 2018 probably did not include estimates to account for additional costs associated with COVID-19 or for subsequent inflationary cost increases. Price-based USG contracts are not likely to include automatic contractual relief for economic cost increases.
- *Regulatory compliance* — Even commercial or price-based USG contracts are subject to USG regulations. FAR Part 12² includes unique requirements, and contractors need to have a comprehensive understanding of the relevant rules and regulations that come with many federal government contracts, such as labor-related requirements (e.g., equal opportunity and affirmative action) and supply chain restrictions (e.g., the Buy American Act's domestic content requirements and "Prohibition on Contracting for Certain Telecommunications and Video Surveillance Services or Equipment" in FAR Subpart 52.204-25). Aerospace companies looking to enter the USG aerospace industry or to expand into larger public sector contracting opportunities need to be aware of these requirements and be ready to comply or risk losing out on future opportunities.

Compliance Risks and Considerations Related to Cost-Based USG Contracting

Given that many contracts in the aerospace industry may be cost-based because of the high risk and uncertainty associated with such projects, the need to provide cost accounting is a critical consideration for USG contractors. The following points should be considered:

- *Supporting proposals* — FAR Part 15 focuses on negotiated acquisitions and prescribes the format and methodology for proposing costs. Under FAR 15.404-3, a contractor or subcontractor must submit cost or pricing information, and the contractor may be required to certify that all facts supporting the proposal are "current, accurate, and complete." Failure to comply with the requirements of FAR Part 15 could lead to allegations of defective pricing and result in downward price adjustments, cost disallowance, and, potentially, violations of the False Claims Act.
- *Unallowable costs* — In accordance with FAR Part 31,³ certain costs are expressly unallowable in USG contracts (e.g., costs related to public relations and advertising, entertainment, interest). USG contractors must ensure that such costs are identified and excluded from USG reimbursement claims; failure to do so can result in penalties in addition to disallowance of the costs. The permissibility of other costs under FAR

² FAR Part 12, "Acquisition of Commercial Products and Commercial Services."

³ FAR Part 31, "Contract Cost Principles and Procedures."

Part 31 may depend on the reasonableness of the specific cost and the sufficiency of supporting documentation (e.g., travel, employee compensation, employee morale, professional and consulting costs). USG contractors that hold or are pursuing cost-based contracts need to develop policies and procedures to assess the allowability of costs in accordance with FAR and ensure that financial management systems are set up to segregate and exclude unallowable costs from USG reimbursement claims.

- *Indirect cost pools and bases* — To bid and perform on cost-based contracts, USG contractors need to be able to identify the total cost (i.e., both direct and indirect costs) that is allocable to the USG contract. To identify and allocate indirect costs, contractors must have a detailed understanding of their operations and identify the causal or beneficial relationships between their indirect cost pools and direct activity to be used as bases in the allocations. The reasoning for incurring and grouping indirect costs, as well as the bases for allocating them, should be documented in a written policy and updated contemporaneously.

Contracts may be subject to CAS, which provide detailed criteria regarding how costs are to be assigned, measured, and allocated to USG contracts and require consistency in the application of cost accounting practices from one contract to the next within a CAS segment.⁴ The standards may also require (1) the written disclosure of cost accounting practices, (2) the notification of any changes in cost accounting practices, and (3) an assessment of the impact of cost accounting practice changes. CAS increase the number of cost accounting compliance obligations and can result in contract price adjustments. In addition, if the USG incurs increased costs associated with a CAS noncompliance, the contractor would also be charged daily compound interest from the date of the USG's overpayment.

- *Documentation and auditability* — As previously discussed, cost-based contracts can result in more extensive USG oversight and audits, so USG contractors must maintain detailed and accurate records of their costs and must be prepared for potential USG audits, including audits related to proposal pricing, billing and payment vouchers, compensation reasonableness, and incurred costs. If documentation supporting USG contract costs is not readily available and transparent, there is increased risk that USG auditors will misinterpret or misunderstand supporting documentation and then question the allowability or allocability of costs in USG contracts.

Conclusion

USG contractors that are new to the aerospace industry will need to provide training to personnel regarding FAR and CAS compliance requirements as well as to continuously monitor changes to FAR and CAS regulations. Such companies may want to consider consulting with an experienced USG contracts adviser who can help them navigate the complex landscape of USG contracting and cost accounting. Deloitte has experts with decades of experience in USG contracting that can help companies interpret USG contract requirements, design and model indirect cost rate structures, and assess the applicability of CAS, as well as provide USG audit readiness services related to CAS, incurred cost allowability, and financial management systems.

⁴ As defined in Title 48 of the Code of Federal Regulations Part 9904.410-30, a segment "means one of 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 terms include Government-owned contractor-operated (GOCO) facilities, and joint ventures and subsidiaries (domestic and foreign) in which the organization has a majority ownership. The term also includes those joint ventures and subsidiaries (domestic and foreign) in which the organization has less than a majority of ownership, but over which it exercises control."

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