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January 29, 2002

MEMORANDUM FOR DISTRIBUTION

Subj: COST ACCOUNTING STANDARDS - CHANGES IN COST
ACCOUNTING PRACTICE

Encl: (1) OUSD (AT&L) DP memo of January 17, 2002

Enclosure (1) is forwarded providing guidance to assist contract administration personnel in determining whether a change in cost accounting practice has occurred. The requirements at 48 CFR 9904.302-2, Changes to a cost accounting practice, provide a general definition of what constitutes a change in cost accounting practice. Enclosure (1) provides guidance for use in implementing that definition. In particular, the guidance focuses on cost accounting practice changes related to cost allocations that occur in conjunction with organizational changes.

Any questions or comments may be addressed to Ms. Joyce L. Runyan (703) 602-2704, fax (703) 602-2117, or e-mail at runyan.joyce@hq.navy.mil.

A handwritten signature in black ink, appearing to read "Peter M. Chase", is positioned above the typed name.

Peter M. Chase
Director, Policy and Resources
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January 17, 2002

MEMORANDUM FOR ASSISTANT SECRETARY OF THE ARMY
(ACQUISITION, LOGISTICS AND TECHNOLOGY)
ASSISTANT SECRETARY OF THE NAVY
(RESEARCH, DEVELOPMENT AND ACQUISITION)
ASSISTANT SECRETARY OF THE AIR FORCE
(ACQUISITION)
DIRECTORS OF DEFENSE AGENCIES

SUBJECT: Cost Accounting Standards - Changes in Cost Accounting
Practice

The purpose of this memorandum is to provide guidance to assist contracting personnel in determining whether a change in cost accounting practice has occurred.

For contracts that are subject to the Cost Accounting Standards (CAS), the contract clauses at FAR 52.230-2 through 52.230-5 require that the contract price or cost allowance be adjusted if a contract is affected by a change in cost accounting practice. The requirements at 48 CFR 9904.302-2, Changes to a cost accounting practice, provide a general definition of what constitutes a change in cost accounting practice. The attached paper provides guidance for use in implementing that definition.

If you have any questions regarding this memorandum, please contact Mr. David J. Capitano, Senior Procurement Analyst, at 703-602-4245.

Deidre A. Lee
Director, Defense Procurement

Attachment:
As stated



**Guidance Paper
Changes in Cost Accounting Practice**

BACKGROUND

This paper provides guidance to the Administrative Contracting Officer (ACO) and auditor for use in determining whether there is a change in cost accounting practice. In particular, the guidance focuses on cost accounting practice changes related to cost allocations that occur in conjunction with organizational changes.

SUMMARY

Organizational changes can result in cost accounting practice changes. However, organizational changes by themselves are not cost accounting practice changes. In determining whether a cost accounting practice change has occurred, the ACO and auditor should focus on whether accounting methods or techniques have changed as part of the organizational change. When a contractor makes an organizational change, the ACO should request the auditor to evaluate the contractor's accounting practices to determine (1) if they are CAS compliant (examples contained in this memorandum assume the accounting practices before and after the change comply with applicable CAS), and (2) whether a change in cost accounting practice has occurred. The ACO and auditor should use the following to determine if a change in cost accounting practice has occurred:

- A. For purposes of cost allocation, a change in cost accounting practice occurs (except as noted in B. below) when there is a change in the method or technique for:
1. Determining whether a cost is directly or indirectly allocated,
 2. Determining the composition of the cost pools,
 3. Determining the selection of the allocation base, or
 4. Determining the composition of the allocation base.

- B. The initial adoption of a cost accounting practice for the first time a cost is incurred or a function is created is not a change in cost accounting practice. The partial or total elimination of a cost or the cost of a function is also not a change in cost accounting practice.
- C. The transfer of contract work from one segment to another is not a change in cost accounting practice or a CAS 401 noncompliance, provided cost accounting practices at the segments remain unchanged.
- D. When there is a change in cost accounting practice, only affected CAS-covered contracts are subject to price or cost adjustments.

GUIDANCE

A. Changes in cost allocation practices

48 CFR 9903.302-1(c) defines a cost accounting practice for cost allocation as follows:

Allocation of cost to cost objectives, as used in this part, includes both direct and indirect allocation of cost. Examples of cost accounting practices involving allocation of cost to cost objectives are the accounting methods and techniques used to accumulate cost, to determine whether a cost is to be directly or indirectly allocated, to determine the composition of cost pools, and to determine the selection and composition of the appropriate allocation base.

The phrase "to accumulate cost" as used in this definition means the collection of cost data for the functions and activities in specified cost pools and activities comprising the allocation bases. Changes in cost accumulation practices generally occur when there is a change in the composition of the cost pool and/or allocation base. Therefore, in determining if there is a change in cost allocation practice, the ACO and auditor should focus on whether there is a change in the method or technique for (1) determining whether a cost is directly or indirectly allocated, (2) determining the composition of the

cost pools, (3) determining the selection of the allocation base, or (4) determining the composition of the allocation base.

1. Determining whether a cost is directly or indirectly allocated

As stated at 48 CFR 9903.302-1(c), allocation of cost to cost objectives includes both direct and indirect allocation of cost. Accounting methods or techniques used to determine whether a cost is directly or indirectly allocated are cost accounting practices. A change in cost accounting practice occurs if the contractor changes its cost allocation practice from direct to indirect, or vice versa.

Specific identification of a cost to a final cost objective or to a segment is a direct allocation method. Accumulating a cost in a specified indirect pool or home office pool for the purpose of allocation to multiple cost objectives or segments is an indirect allocation method. A change in direct vs. indirect allocation can occur (1) within a segment, (2) within a home office, (3) between two or more segments, (4) between two or more home offices, or (5) between a segment and a home office.

For example, if the contractor reorganizes its engineering group within Segment F and first line supervision costs that were formerly charged to the engineering overhead pool are now charged direct to cost objectives, the contractor has changed its method of allocating the cost of the first line supervision function from indirect to direct.

In another example, Segment S performs its own computer services function. Segment T performs the computer services function for Segments T and U, charging the costs between these two segments using an indirect cost allocation method. The contractor transfers the computer services function for Segment S to Segment T. After the transfer, Segment T performs the computer services function for Segments S, T, and U. Segment T charges the costs to the benefiting segments (S, T, and U) using an indirect cost allocation method. This is a change from direct to indirect allocation for Segment S (the computer services costs were directly identified at Segment S prior to the transfer but are indirectly allocated to Segment S after the transfer). This is not a change from direct to indirect allocation for Segments T or U (computer services costs are indirectly allocated before and after the transfer).

In another example, the payroll function was formerly performed at Segments A and B but is now performed at the home office level. This is a change in accounting practice for Segments A and B if the home office indirectly allocates the costs of the payroll function to Segments A and B. However, it is not a change in accounting practice if the home office directly identifies the costs of the payroll function to Segments A and B.

2. Determining the composition of cost pools

Functions and activities

Indirect cost pools are composed of functions and activities (e.g., machining supervision, purchasing, security, inspection, and insurance administration). 48 CFR 9903.302-2(a) defines "function" as "an activity or group of activities that is identifiable in scope and has a purpose or end to be accomplished." A change to a method or technique used to determine the composition of cost pools occurs when a contractor changes the functions or activities that compose the indirect cost pool.

Combining indirect cost pools

When a contractor combines two or more indirect cost pools, there is a change in pool composition for the cost objectives of the previously separate pool(s) if the functions or activities of the previously separate pool(s) are not generally the same as the functions and activities of the new combined pool. This applies to the combination of two or more indirect cost pools within a segment, within a home office, between two or more segments, between two or more home offices, or between a segment and a home office.

For example, Segment A of Company 1 has an assembly overhead pool. The functions and activities of the assembly overhead pool are assembly supervision, materials inspection, and machine maintenance. Company 1 purchases Company 2, which previously did fabrication and other work for Company 1. The former Company 2 is established as new Segment B in Company 1. The functions and activities of the new Segment B's fabrication pool are fabrication supervision and tool calibration. The fabrication pool of the new Segment B is combined with the assembly pool of Segment A. This is a change in pool composition for the cost objectives of the former assembly pool

since the functions and activities of the former assembly pool are not generally the same as the functions and activities of the combined pool. This is also a change in pool composition for the cost objectives of the former fabrication pool since the functions and activities of the former fabrication pool are not generally the same as the functions and activities of the combined pool.

Dividing indirect cost pools

When a contractor divides a single indirect cost pool into two or more pools, there is a change in pool composition for the cost objectives of a divided pool(s) if the functions or activities in the divided pool(s) are not generally the same as the functions and activities of the former single pool. This applies to the division of two or more indirect cost pools within a segment, within a home office, between two or more segments, between two or more home offices, or between a segment and a home office.

For example, Segment B has a single overhead pool that includes two functions, building maintenance and security. Segment B divides the single overhead pool into two indirect cost pools. Pool 1 includes the building maintenance function while Pool 2 includes the security function. This is a change in pool composition for the cost objectives in Pool 1 since the functions of Pool 1 and the functions in the former single indirect cost pool are not generally the same. There is also a change in pool composition for the cost objectives in Pool 2 since the functions in Pool 2 and the functions in the former single indirect cost pool are not generally the same.

Transfer of functions

The guidance that follows applies to a transfer of a function within a segment, within a home office, between two or more segments, between two or more home offices, or between a segment and a home office.

A transfer of a function or activity from one pool to another is not a change in pool composition for the cost objectives of the transferring pool (i.e., the pool from which the function or activity is transferred) if the transferring pool receives an allocable cost of the function or activity from the receiving pool. In all other cases, a transfer of a function or activity from one pool to another is a change in

pool composition for the cost objectives of the transferring pool.

A transfer of a function or activity from one pool to another is not a change in pool composition for the cost objectives of the receiving pool if the receiving pool contained that function or activity prior to the transfer. In all other cases, a transfer of a function or activity from one pool to another is a change in pool composition for the cost objectives of the receiving pool.

For example, one of the functions in Segment C's engineering overhead pool is production engineering supervision. Segment C also has a production overhead pool that does not include a production engineering supervision function. Segment C moves the production engineering supervision function from the engineering overhead pool to the production overhead pool. This is a change in pool composition for the cost objectives in the engineering overhead pool because that pool does not contain the production engineering function after the transfer. This is also a change in pool composition for the cost objectives of the production overhead pool because that pool did not contain the production engineering function prior to the transfer.

In another example, Segment K has an indirect cost pool that includes an engineering testing function. This function is transferred from Segment K to a Segment L indirect cost pool that did not previously include an engineering testing function. This is a change in the pool composition for the cost objectives in Segment K's indirect cost pool because that pool does not contain the engineering testing function after the transfer. This is also a change in pool composition for the cost objectives of Segment L's indirect cost pool because that pool did not contain the engineering testing function prior to the transfer.

Disclosed and established practices

When determining whether an accounting change has occurred, the ACO and auditor should focus on the disclosed and established practices that define and describe the significant functions and activities of the indirect cost pool(s). The Disclosure Statement may or may not describe all the significant functions and activities of an indirect cost pool(s).

Variations in Costs

Costs that are associated with defined pool functions may vary at different points in time (e.g., asset purchases, receipt of contracts, or implementation of new technology). Variations in the size of individual costs over time that do not result from a change in the defined pool functions are not changes in cost accounting practice. For example, if a contractor purchases a building whose maintenance costs fall within a previously defined building maintenance function, maintenance costs relating to the purchased building increase the size of the indirect cost pool but do not affect its composition.

3. Determining the selection of the allocation base

The selection of the allocation base refers to the allocation base measure (e.g., direct labor dollars, direct labor hours, direct material costs, total cost input, or a resource consumption measure such as computer usage or square footage). An allocation base is used to measure the beneficial or causal relationship between the costs in an indirect cost pool and the cost objectives to which the cost pool is allocated. A change in the selection of the allocation base is a change in cost accounting practice. For example, if a contractor changes its base for allocating its engineering overhead costs from direct labor dollars to direct labor hours, this is a change in the selection of the allocation base. A change from a value-added to a total cost input allocation base for allocating the costs of a general and administrative expense pool is another example of a change in the selection of the allocation base.

4. Determining the composition of the allocation base

A change in the composition of the allocation base occurs when there is (a) a change in the elements of the allocation base, or (b) a change in the activities that are included in the base. A volume change in the base (e.g., addition/deletion of contracts or segments) by itself is not a change in the composition of the base.

The specific nature of the make up of the allocation base is addressed in Preamble J of the CASB regulations on cost accounting practice changes, which states in part:

For allocation purposes the Board has concluded that the level of detail should include not only the types of base, e.g.,

direct labor, but also the composition of that base, e.g., the elements of labor costs comprising the base.

Thus, the composition of the allocation base includes the elements that make up the allocation base measure (e.g., direct labor dollars plus overtime premium; direct labor dollars plus fringe benefits). A change in the elements that make up the allocation base is a change in cost accounting practice. For example, a change from only direct labor dollars to direct labor dollars plus overtime premium is a change in the composition of the allocation base.

The composition of the allocation base also encompasses the activities represented by the allocation base (e.g., systems engineering, design engineering, fabrication) that are related in some way to the activities in the cost pool. A change in the activities that are included in the allocation base is a change in the composition of that base. For example, a change from a machining direct labor dollars allocation base to an assembly direct labor dollars allocation base is a change in the composition of the allocation base. However, a change in the composition of the allocation base does not include variations in costs caused by volume fluctuations. For example, a contractor that purchases a new segment and adds it to its home office allocation base does not change the composition of the home office allocation base.

B. Initial Adoption of an Accounting Practice/Elimination of a Cost or Cost of a Function

CFR 9903.302-2(a) states that the initial adoption of a cost accounting practice the first time a cost is incurred or a function is created is not a change in cost accounting practice. It also states that the partial or total elimination of a cost or the cost of a function is not a change in cost accounting practice.

When a function is transferred between segments, between home offices, or between a segment and a home office, this does not constitute the creation or elimination of a function for the segment(s) or the home office(s). Similarly, the merger of two or more segments or home offices also does not constitute the creation or elimination of a function for any of the segments or home offices.

For example, if Segment H establishes a new security function, this would be the creation of a new function for Segment H. However, if the security function was transferred from Segment G to Segment H, this would not be the creation of a new function for Segment H or the elimination of the function for Segment G.

C. Transfer of Contract Work

The transfer of work on a contract from one existing segment to another existing segment is not a change in cost accounting practice or a CAS 401 noncompliance, provided cost accounting practices at the segments remain unchanged. For example, when a contractor transfers contract work from Segment A to Segment B, there is no change in cost accounting practice or CAS 401 noncompliance provided the cost accounting practices of Segments A and B have not changed.

When work is transferred from one segment to another, the contract often will not incur the costs as originally estimated. Instead, the contract will incur costs in accordance with the disclosed or established cost accounting practices of the segment to which the work was transferred. The contract may incur the cost of the transferred work under a different indirect cost pool (e.g., Segment B's overhead pool instead of Segment A's overhead pool) or a different cost element (e.g., intra-company transfers). However, this is a business decision concerning how the work will be performed during contract performance (similar to a make or buy decision), rather than a change in the cost accounting practices of either segment. If the cost accounting practices of the segments remain the same, this is not a change in cost accounting practice or a CAS 401 noncompliance. The established cost accounting practices of the two contractor segments were consistently used to estimate and accumulate each segment's costs.

D. Affected CAS-Covered Contracts

Affected CAS-covered contracts are those contracts on which the cost accounting practice change occurred. When there is a change in cost accounting practice, affected CAS-covered contracts are the only contracts that are subject to contract price or cost adjustments. A cost accounting practice change occurs on a contract when a contractor or subcontractor uses one cost accounting practice to estimate costs and a changed cost accounting practice to accumulate and report costs under the contract.

Contracts may be impacted by events other than cost accounting practice changes (e.g., volume changes or contract performance changes). When the cost accounting practices for these contracts do not change, they are not subject to CAS contract price or cost adjustments. For example, a contractor merges two indirect cost pools that contain significant functions and activities that are generally the same. Pool A uses a direct labor dollars allocation base; Pool B uses a direct labor hours allocation base; and the combined pool uses a direct labor dollars allocation base. There is a change in the selection of the allocation base for those contracts in the allocation base for Pool B. However, there is no change in the selection of the allocation base for those contracts in the allocation base for Pool A. The affected CAS-covered contracts are those contracts in the allocation base for Pool B since these are the contracts for which a previous cost accounting practice (direct labor hour allocation base) was used to estimate costs and a changed cost accounting practice (direct labor dollar allocation base) is used to accumulate and report costs. Thus, the contracts in the allocation base for Pool B are the only contracts that are subject to price or cost adjustments.