COURSE 8, TUTORIAL 2

WHAT ARE THE REQUIREMENTS OF AN APPROVED ACCOUNTING SYSTEM?

The expectations regarding the sophistication of a small business' accounting system changes between Phase I and Phase II. With Phase I SBIR or STTR awards, the Federal government usually expects the small business to have a basic system, as the Phase I awards are relatively small. In Phase II, however, the Federal government has higher expectations. One reason is because a Phase II is for a lot more money—around $1 million, versus only $150,000 in Phase I. The contracting officers need to be confident that you have, among other things, accurately estimated your indirect rate. The ability to calculate a good indirect rate comes from a good accounting system that differentiates direct from indirect costs, and isolates unallowable ones. In Phase II another change is likely. It is more likely that the agency will shift from making a "fixed price" award, commonly used in Phase I to a "cost plus fixed fee" or CPFF award. A firm fixed price or FFP award requires a recipient to perform the work necessary to produce the deliverables specified in the contract/grant for an established dollar amount. FFP awards therefore incentivize the contractor to control costs and impose minimum administrative burden on the contracting parties. A CPFF award means that the Government will pay the small business based on the documented costs of doing the Phase II work, so your accounting system has to be "smart" enough to keep track of all the costs, and distinguish costs on one project from those of another.

DCAA AND PREAWARD SURVEYS

Therefore, if an SBIR/STTR agency is contemplating giving you a Phase II award, they may require a preaward "survey", that is an audit. Many of the SBIR/STTR agencies, except for National Institutes of Health (NIH) and National Science Foundation (NSF) rely on the Defense Contract Auditing Agency (DCAA) to perform this survey. Although DCAA is part of the Department of Defense, they do such work for many other agencies.

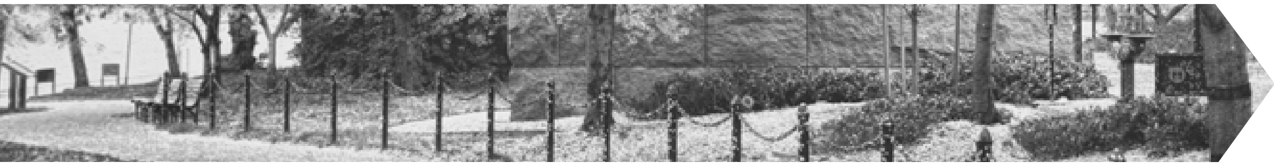
A DCAA preaward survey will include at least two components, and perhaps as many as four. The two mandatory components are:

1. Assess your company's financial stability. Simply put, the DCAA will evaluate whether your company is stable enough to complete a two year Phase II project; and

2. Evaluate the suitability of your accounting system.

The two optional components of the preaward survey are:

1. Evaluate the indirect rates you propose to charge on a Phase II project. During a DCAA audit, they will assess how your indirect rates were calculated and make a judgment whether they are suitable for use in Phase II billing.



2. Confirm that you are current on your payroll tax deposits. This is a policy statement; the Federal government doesn't want to give an award to a firm that isn't playing by the rules concerning items such as payroll taxes.

To see the content and forms used to conduct these preaward surveys, it's recommended that a small business take a look at the DCAA guide Information for Contractors. This guide is referenced frequently by agencies that have an SBIR/STTR program, so it is helpful to become familiar with it (both in terms of what it contains, and what it doesn't). Be aware, that this guide is not specific to SBIR/STTR.

It may take DCAA some time to come to your business to conduct this preaward survey, depending upon their backlog of work. It also takes longer than usual if you don't have all the documentation available, or if there are issues with your financial stability and/or accounting system (and/or indirect rate or payroll tax deposits, if DCAA decides to look at those factors, as well). This is one reason why there can be an extended time gap between the end of your Phase I project and the start of your Phase II.

EVALUATION OF YOUR ACCOUNTING SYSTEM

Now let's talk about the 10 requirements by which the DCAA will evaluate your accounting system. This list comes from Standard Form SF1408 in the aforementioned Information for Contractors guide.

1. Proper segregation of direct costs from indirect costs.

2. Identification & accumulation of direct costs by contract.

3. Logical & consistent method for allocating indirect costs.

4. Accumulation of costs under general ledger control.

5. A timekeeping system.

6. A labor distribution system charging direct and indirect labor appropriately.

7. Interim determination of costs charged to a contract.

8. Exclusion of unallowable costs.

9. Identification of cost by contract line item.

10. Segregation of preproduction from production costs.

A more detailed version of this list can be found in the Tools section of this tutorial.

DCAA reports that they see the most errors around requirements #1, 5, 7 and 8. The one that may cause you the most difficulty, as well as heartburn, is #5 – A Timekeeping System. Let's talk more about it.

IMPORTANCE OF TIMEKEEPING SYSTEMS

The Federal government expects a small business that receives Federal contracts and grants to keep timesheets. There are instances where contract/grant recipients didn't know this, and found out too late—when the DCAA or other auditor arrives to evaluate their indirect rate charges. If you don't keep timesheets, then you lack any way to document or prove that you incur the largest single indirect cost of many small businesses, namely the employees' time spent running their business, writing proposals, preparing and updating commercialization plans, and similar non-client activities.

Because timesheets are the proof required behind your indirect rate, it should be understood that timesheets must be kept by everyone in your business, even if they are the president or CEO, and even if they never perform any work billable to a customer (i.e., direct). Imagine the impact on your indirect rate IF your CEO's labor costs associated with running your business can't be counted—you would lose money that you otherwise could collect to cover part of his/her salary and benefits.

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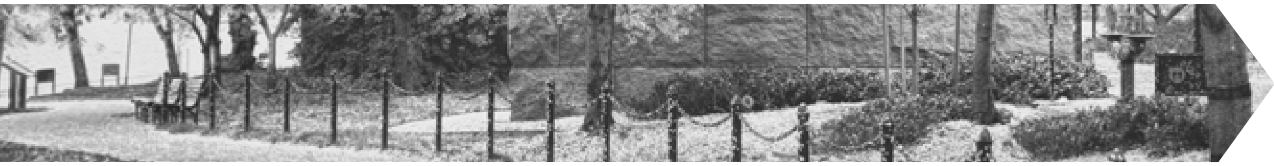
We recommend that you read the information on timesheets that are discussed in the aforementioned Information for Contractors guide - specifically review Enclosure 2, Section 4 of the 2012 edition. Actual time should be recorded (not percentages of the day, as is popular at some universities), especially when it adds up to more than 8 hours in a work day. Entries must be made daily. Time sheets must list separately each contract, grant and other directly billed projects of the company on which the employee is working.



Don’t make the fallacious assumption that timesheets are only required by agencies like DOD that make SBIR/STTR awards as contracts. Granting agencies like NIH and NSF also expect that you keep timecards. Quoting the NSF, “Organizations receiving NSF awards are required to have adequate timekeeping systems. Time and effort records must be maintained for an organization’s employees so that salary charges to a grant can be verified.”

Sadly, although time sheets are imperative for SBIR and STTR awardees, there are few examples of acceptable timesheets on the awarding agencies’ websites. As a starting point you can look at the one provided by NSF. The only drawback of this example is that it is a bi-monthly time sheet (i.e., employees would turn it in only twice a month), whereas it is strongly recommended that timesheets are handed in weekly in order to ensure employees are filling out their timecards on a daily basis.

Although we have focused on DCAA in this tutorial, you can find similar guidance for other agencies with SBIR/STTR programs. NSF, for example, has stringent expectations of your accounting system when you receive a Phase II. The firm’s financial capability will be considered as well as the adequacy of the accounting system, and timesheets are of concern. This site does contain a link to the sample timesheet mentioned above, and it is in Excel format.