CPA DEPARTMENT

What Government Contractors Need to Know About Common DCAA Contract Audits

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Introduction

Defense Contract Audit Agency (DCAA), established in January 1965, is the government agency accountable for auditing Department of Defense (DoD) contracts. DCAA services are also available and accessed by other non- DoD government agencies for auditing, accounting, and financial advisory services. The objective of DCAA is to ensure taxpayers and the military receive benefits for tax dollars expended for the purchase of equipment, goods, and services. To accomplish this objective, DCAA routinely audits DoD contracts for compliance with Federal Acquisition Requirements (FAR). There are more than 50 kinds of audits performed by DCAA to ensure contractor systems are transparent and accurate.

For simplicity, DCAA categorizes audits into two types:

Pre-Award Audits

As the name suggests, these audits are done before a contract is awarded. A Pre-Award audit might include an audit of proposal pricing, forward pricing rates, or a survey of the accounting system.

Post-Award Audits

Post-Award audits are those performed after a contract is awarded. Post-Award audits include audits of costs acquired under the contract, in accordance with the Truth in Negotiations Act (TINA), Cost Accounting Standards (CAS), fiscal potentials, or claims made against them by other contractors.

The goal of a Post-Award audit is to validate that the costs comply with Federal Acquisition Regulations (FAR), to ensure costs were reasonable, allowable, and allocable to contracts, and to determine whether the contractor submitted accurate, complete, and current cost or pricing data.

Contractor Business System Audits

Business system audits are designed to determine a contractor's compliance with six (6) DFARS business system requirements. Only three of the business system audits are conducted by DCAA: these include accounting, estimating, and material management systems. The other three audits are performed by the Defense Contract Management Agency (DCMA).

System audits are extensive evaluations of a contractor's business systems, performed in order to determine whether the systems are sufficient to properly account for government contracts. These are important audits for government contractors to understand; however, they fall outside the scope of this document.

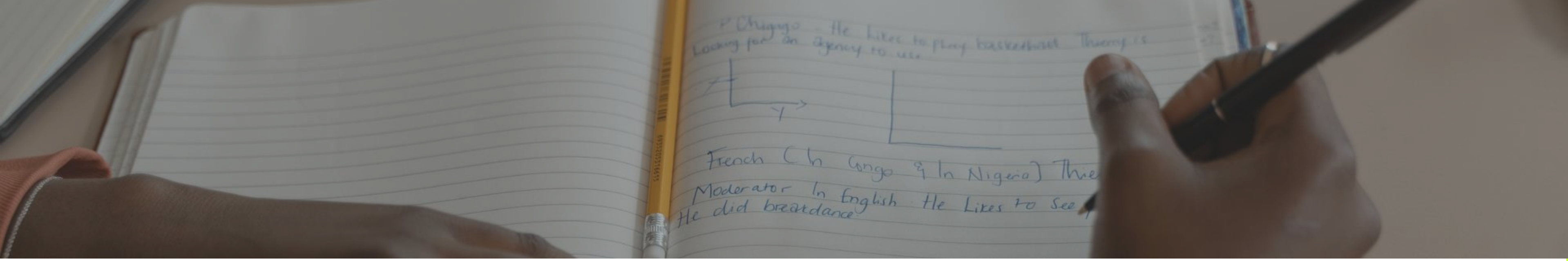
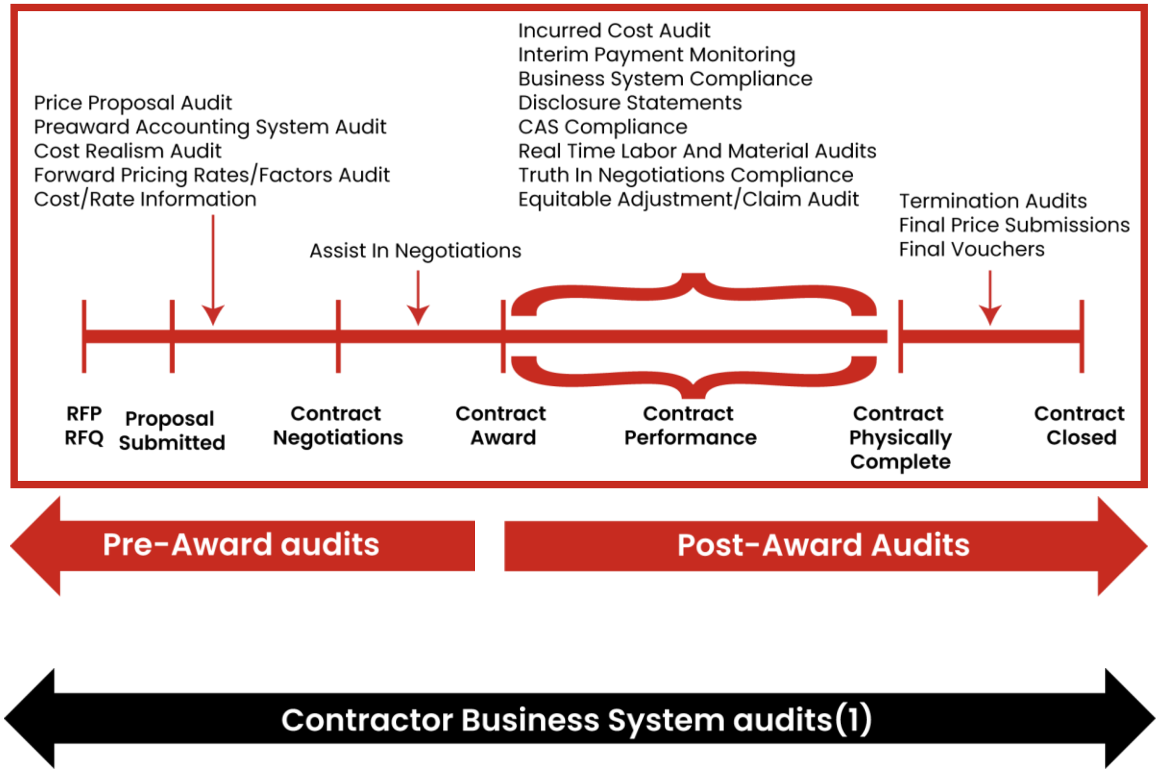


Figure 1 The Acquisition Lifecycle



Our review of common DCAA audits focuses on Pre-Award and Post-Award Audits. We will separately discuss business system audits, which are significantly greater in scope.

Executive Summary

Government contractors and aspiring government contractors operate in a much more regulated environment than commercial entities. By developing an understanding of these commonly performed audits and by establishing systems, policies, and procedures to ensure compliance with the requirements of these audits, contractors will establish a structure for success. As contractors grow, additional requirements are imposed in the form of Cost Accounting Standards and Disclosure Statements. These standards impose Business System requirements, which are much broader and more encompassing than the audits described here and will be addressed as a separate topic.

Commonly Performed Audits

DCAA's priorities and focus change over time, so not all audits are commonly seen all the time. However, there are several audits that do tend to be seen with great frequency. A few of the most common audits are the topic of this discussion.

Commonly seen Pre-Award Audits:

- Pre-Award Survey
- Proposal Audit

Commonly seen Post-Award Audits:

- Public Voucher Audit
- Floor Check
- Provisional Billing Rate Audit
- Incurred Cost Audit
- Contract Closeout

Pre-Award Survey

Purpose

The primary objective of the Pre-Award Survey, documented on Standard Form 1408 (SF 1408), is to determine whether the design of a prospective Contractor Accounting System is acceptable for the award of a federal government contract. The Pre-Award Survey is used when a company is new to government contracting or new to cost reimbursement contracts. It involves the evaluation of the design effectiveness of the accounting system and not operating effectively. This means the system may not be fully operational, and the assessment does not generally involve tests of transactions. The assessment is quick to perform and provides a recommendation on the adequacy of the accounting system.

Scope

The Pre-Award Survey scope is restricted to determining whether the design of the prospective accounting system to accumulate costs under a government contract is adequate. Typically, the auditor will make inquiries about the accounting system, inspect documentation, including policies and procedures, and request a demonstration of the design.

Considerations

The auditor is generally faced with one of three scenarios when a request from the contracting officer is received to perform a Pre-Award Survey.

1. If a contractor has an active government contract, the auditor verifies the adequacy of the system by observing the accounting system in operation. The auditor will also review DCAA's files for historical information related to the contractor, and if prior information does exist about the contractor in DCAA's files, the information is offered to the contracting officer. If there are known system deficiencies or if DCAA has identified problems with the contractor's invoice vouchers, this information will also be provided to the contracting officer.

2. If the Pre-Award Survey is a follow-up request to a previous Pre-Award Accounting System Survey, the auditor must determine whether a new assessment is necessary. To make that determination, the auditor will review the following questions:

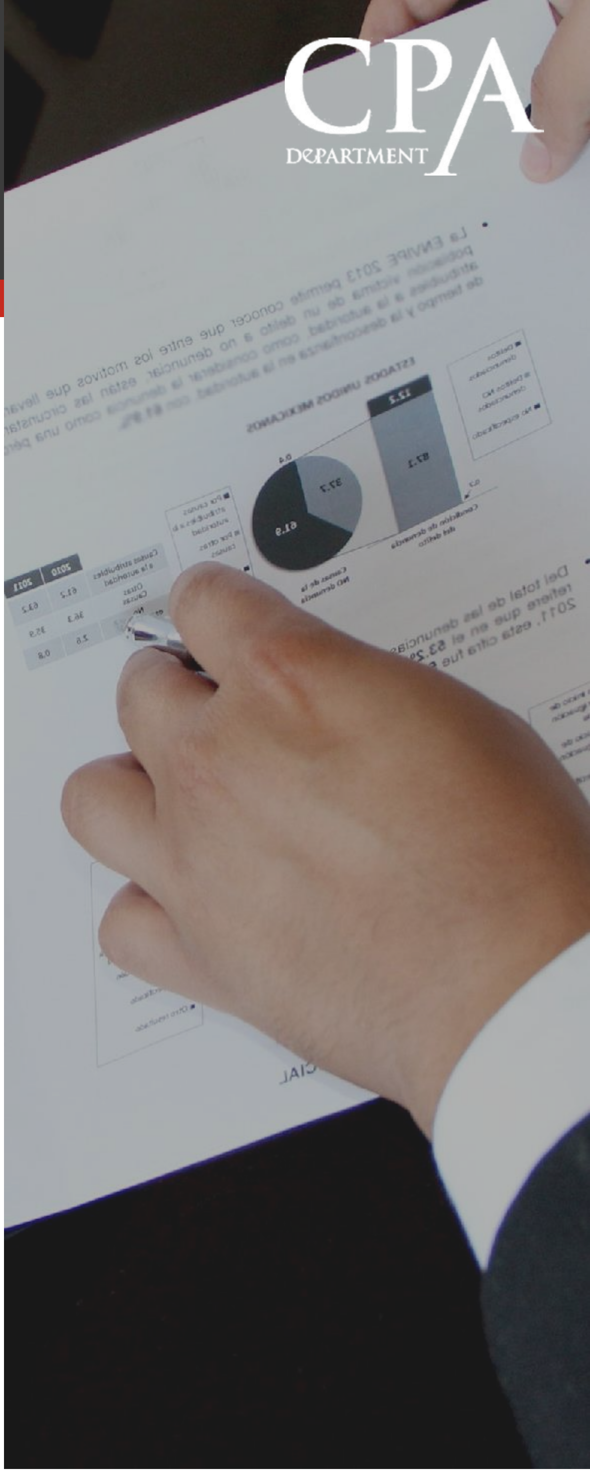
   ◊ When was the last Pre-Award Survey completed? If the previous survey is currently less than 12 months old, and if the system has not changed, a follow-up to the prior assessment will be appropriate. The review has a reduced scope and duration compared to a full Pre-Award Assessment. However, if the previous survey was performed more than 12 months prior, a new and full Pre-Award Assessment will be performed.

   ◊ Are there any changes that have occurred in the contractor's system since the last Pre-Award Survey that was completed? If the contractor's accounting system has changed, a new and full Pre-Award Assessment will be performed.

3. The third scenario occurs when a request for a Pre-Award Accounting System Survey is received for a contractor that hasn't yet established their accounting design, structures, policies, and procedures. In this scenario, the auditor contacts the contracting officer to inform the contractor the survey cannot be completed due to insufficient demonstration of the design.

Audit Content

The following checklist is followed during a Pre-Award Survey.



STEP 1:

Determination of whether the contractor's accounting system is maintained in accordance with GAAP (Generally Accepted Accounting Principles).

STEP 2:

Proper segregation of direct costs from indirect costs.

DCAA will review the accounting system to determine if direct costs are segregated from indirect costs.

Direct costs are defined in FAR 31.202 as any cost that can be identified specifically with a particular final cost objective (e.g., a contract). An example would be labor specifically identified for the contract or materials purchased specifically for the contract. At times, contractors may find it impractical to identify costs specifically for a contract. FAR 31.202 states that a direct cost can be treated as an indirect cost if the dollar amount is minor; it is treated the same way for all contracts in a contractor's accounting system, and that treatment produces substantially the same results as treating the cost as a direct cost.

Indirect costs are defined in FAR 31.203 as any cost not directly identified with a single, final cost objective, but identified with two or more final cost objectives or an intermediate cost objective. An example of an indirect cost would be the lighting in a manufacturing area that houses the work of several contracts. The lighting benefits all contracts but cannot practically be identified to a specific contract. These types of costs are normally placed in an overhead or General and Administrative (G&A) expense pool and allocated to contracts on some equitable basis.

The cost accounting system must identify what costs are considered direct and what costs are considered indirect. Once these criteria are defined, they must be consistently applied.

STEP 3:

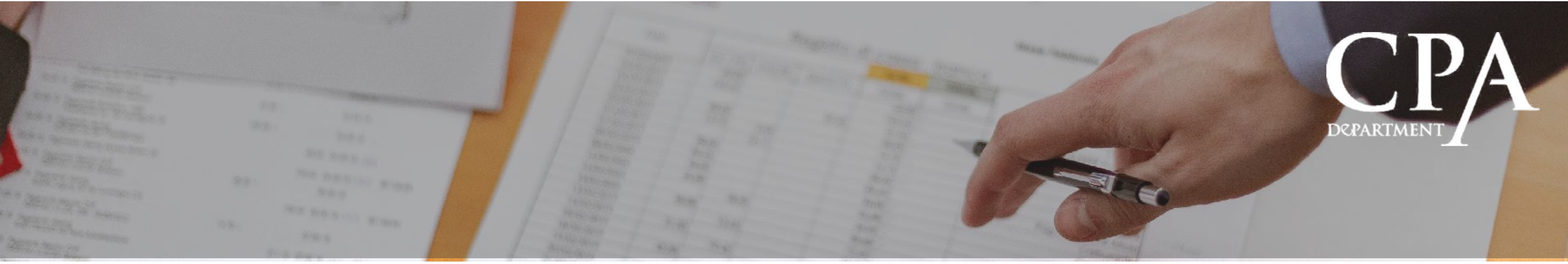
Accumulation of direct costs by contract.

During this step, the auditor is mainly concerned with whether the contractor system is designed to generate a subsidiary job cost ledger.

STEP 4:

Allocation of indirect costs to intermediate and final cost objectives (contracts).

DCAA will determine if indirect costs are allocated to cost objectives based upon relative benefits received or other equitable relationships, as required by FAR 31-201- 4, “Determining allocability,” and FAR 31-203, “Indirect costs.”



Fundamentally, this means a cost may not be allocated as an indirect cost to a final cost objective if other costs incurred for the same purpose have been included as direct costs of that or any other cost objective. For example, if a contractor wishes to perform a contract that requires three firemen on 24-hour duty at a fixed post to provide protection against damage to highly flammable materials used on the contract, but the contractor already has a firefighting force for general protection of the plant, which is treated as an indirect cost and allocated to all contracts, the contractor may charge the cost of three of the post firemen directly to the particular contract requiring them. In this example, the contractor may also allocate a portion of the remaining cost of the general fire-fighting force to the same contract only if the firemen whose costs are being treated as indirect costs can be shown to serve different purposes consistently (that is: (a) costs charged directly to the contract are only costs of three contract-required firemen at a fixed post who are protecting contract materials, and (b) no costs of these firemen who charge directly to a contract are ever included in the indirect cost pool).

STEP 5

All costs are accumulated under general ledger control.

DCAA will determine if the job cost ledger and other books of account can be reconciled with the general ledger and that the company accounting system is controlled by the general ledger.

STEP 6:

A timekeeping system to identify employee labor by intermediate or final cost objective.

Contractors are expected to have policies for timekeeping, such as requiring timesheets to be completed and certified by the employees and approved by the employees' supervisors daily.

1. Timekeeping Procedures. Timekeeping procedures and controls on labor charges are areas of utmost concern. Unlike other costs, labor is not supported by external documentation or physical evidence to provide an independent check or balance. The key link in any sound labor time charging system is the individual employee. It is critical to labor charging internal control systems that management indoctrinates employees to their independent responsibility for accurately recording time charges. To be effective, the internal controls over labor charging should meet the following criteria:

    A. There must be a segregation of responsibilities for labor-related activities. For example, the responsibility for timekeeping and payroll accounting should be separated. In addition, supervisors who are accountable for meeting contract budgets should not have the opportunity to initiate employee time charges. It is recognized that, for a very small company, this type of segregation may not be possible, whereas for a larger company, this type of segregation would be required to have good internal controls over labor costs.

        i. Procedures must be evident, clear-cut, and reasonable so there is no confusion concerning the reason for controls or misunderstanding as to what is and what is not permissible.

        ii. Maintenance of controls must be continually verified and violations must be remedied through prompt and effective action, which serves as a deterrent to prospective violations.

B. Individual employees must be constantly made aware of controls that act as an effective deterrent against violations. Many businesses accomplish this by emphasizing the importance of timesheet preparation in staff meetings, employee orientation, and through the posting of signs throughout the workplace that remind employees of the importance of accurate and current timesheets.

2. Timesheet Preparation. Detailed instructions for timesheet preparation should be established through a timekeeping manual and/or company procedure. Those Instructions should indicate that the employee is personally responsible for:

    A. Recording their time on a daily basis.

    B. Recording time on the timesheet.

    C. The correct distribution of time by project numbers, contract number or name, or other identifiers for a particular assignment. To ensure accuracy, a listing of project numbers and their descriptions should be provided to the employee and maintained in the work authorization system electronically or in a hard copy for the employee to refer to it as needed.

3. Changes to the timesheet. Procedures should be in place that identify the original time charge, the corrected time charge, and documentation from the employee indicating their concurrence with the change.

4. Recording all hours worked whether they are paid or not. This is necessary because labor costs and associated overheads are affected by total hours worked, not just paid hours worked. Therefore, labor rate computations and labor

overhead costs should reflect all hours worked. Unpaid hours worked are termed “uncompensated overtime.” Solicitations over the simplified acquisition threshold contain the provision at FAR 52.237-10, Identification of Uncompensated Overtime, which details disclosure requirements for uncompensated overtime.

5. Certifying the hours on the timesheet reflect the hours worked and the appropriate cost objective at the end of each work period.

STEP 7:

Determination of whether the contractor’s labor distribution system charges direct and indirect labor to the appropriate cost objectives.

Once an employee’s time is segregated, the costs must be allocated to the appropriate cost objective(s).

STEP 8:

Determination of whether costs are charged to contracts at least monthly.

DCAA will determine if the accounting system produces appropriate reports that show the results of charges to contracts.

STEP 9:

Ensuring unallowable costs are excluded from costs charged to government contracts. Unallowable costs are identified in FAR 31, Contract Cost Principles and Procedures, or within contract provisions.

The auditor will ensure the contractor has in place an effective system for identifying and excluding unallowable costs from being charged to the government, including costs directly associated with unallowable costs. There is particular attention paid to those costs FAR identifies as expressly unallowable. Costs mutually agreed to be unallowable between the contractor and the CO also may not be proposed or billed. DCAA will determine if the accounting system identifies these unallowable costs and segregates them in the books and records. While these costs may be legitimate business expenses, and deductible from revenue for tax and reporting purposes, they will not be accepted by the U.S. Government as allowable contract costs. FAR 42.709 authorizes the CO to assess a penalty if a contractor claims an expressly unallowable cost in (1) the final indirect cost rate proposal or (2) the final statement of costs incurred or estimated to be incurred.

STEP 10:

Identification of costs by contract line item and units (as if each unit or line item were a separate contract) if required by the proposed contract.

Some contracts require that the cost of certain items be readily identifiable. In such cases, DCAA will review a contractor's accounting system to determine if the system can provide the level of detailed accounting required, and thus comply with such requirements.

STEP 11:

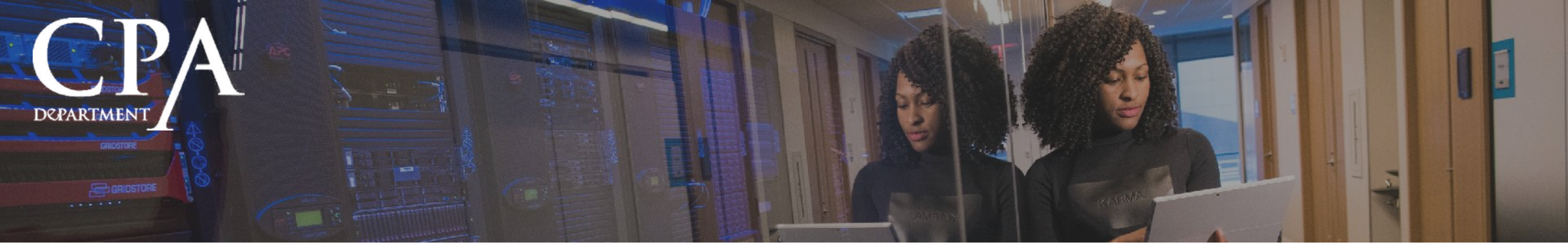
Segregation of preproduction cost from the production cost.

For government contractors performing manufacturing, accounting systems must segregate preproduction costs from production costs.

STEP 12:

Limitations on costs and billings.

The system is observed to identify whether it properly applies limitations on costs and billings. This functionality is required when contracts specify a limitation on costs or billings to the government.



STEP 13:

Accounting for progress payments.

Some contracts permit or require billings to the government and government payment of those invoices to be based upon meeting certain milestones or to closely follow the performance of objectives as outlined in the contract. In this case, the system must account for job performance and milestones, and bill accordingly for services to ensure payments align with work performed.

STEP 14:

Design of system and maintenance of records so that adequate, reliable data is developed for use in pricing follow-on acquisitions.

This important step in the Pre-Award Survey asks the auditor to opine on the reliability of the accounting system to produce data for future estimating efforts.

STEP 15:

Determination if the system is currently in full operation, and if not, which system functions are in operation, set up but not yet in operation, anticipated, or nonexistent.

The Pre-Award Survey can be successful with functions planned yet not implemented. However, the planning must be evident and compliant with FAR.

Key Take-aways

Pre-Award Accounting System Surveys are conducted by DCAA to ensure government contractors have designed an accounting system capable of accounting appropriately for federal flexibly-priced contracts, in compliance with FAR.

The Pre-Award Survey isn't a true audit of the contractor's accounting system. It's rather an overview of the capabilities of the accounting system. In public accounting terminology, it is an "assessment" or "survey."

The Pre-Award Survey requires contractors to establish an accounting system that is compliant with Generally Accepted Accounting Principles (GAAP), segregates and allocates costs, and can perform job costing. It also requires appropriate internal controls and policies and procedures to be established as part of the overall accounting system.

When preparing for the Pre-Award Survey, it is important to pay close attention to the allocation of direct costs to jobs, particularly labor distribution, as well as proper charging of indirect costs to indirect pools.

Proposal Audits

Purpose

Proposal audits are performed to evaluate pricing and estimates submitted in cost proposals by government contractors in connection with the award, administration, modification, or repricing of government contracts. The primary purpose of proposal audits is to evaluate cost estimates for direct labor, material, other direct costs, and indirect costs submitted in a contract proposal.

Scope

The scope of proposal audits varies depending on the size and complexity of the audit and the availability of data. Initially, the auditor will review the proposal for adequacy in accordance with instructions in FAR 15.408, Table 15-2. The responsibility for providing adequate supporting data lies with the contractor. Generally, documentation supporting the proposal should be readily available. Support includes access to personnel, in addition to the documentation and data such as cost records, policies and procedures, and management reports. Auditors will generally require supporting documentation directly from the person responsible for the information.

Considerations

Depending upon the requirements of the contracting officer, DCAA may be requested to audit a portion or the entirety of the submitted proposal. Three potential scenarios may be encountered.

- ◊ Audit of the entire cost proposal
- ◊ Audit of portions of a proposal (certain cost elements, but not the entire proposal)
- ◊ Agreed-upon procedures review (review of certain data or rates, verification tests)

Audit Content

DCAA will request, and contractors should have available, detailed schedules of the labor and overhead rates used in the proposal. The schedules should show calculations, relate to the existing accounting system and historical data, and demonstrate logic used in obtaining future projections.

Examples of the type of data requested to support proposed costs may include:

A. The basis of proposed labor rates and categories including any proposed escalation factors

DCAA will want to understand how proposed labor rates were estimated and will audit the data that supports estimates. Further, the classification of labor categories proposed will be evaluated, as well as the number of hours proposed for each labor category.

B. The basis of proposed material costs

The basis of proposed material costs should include a summary of materials and quantities included in the tasks, orders, or contract line items being proposed, and the basis for their pricing. Basis of pricing can include vendor quotes, invoice prices, competitive bids, and similar documentation. Additionally, raw materials, parts, components, assemblies, and services to be produced or performed by others should be included as well. For all items proposed, contractors should identify the item, and show the source, quantity, and price.

C. The basis of proposed subcontract costs

The basis of proposed subcontract costs includes similar documentation to proposed material costs, demonstrating the contractor has performed an analysis of all subcontractor proposals. Contractors should submit the subcontractor’s cost or pricing data as part of the contractor’s cost or pricing data, as well as an analysis of the subcontractor’s cost or pricing

D. The basis of adequate price competition

Data demonstrating the degree of competition and the basis for establishing the source and reasonableness of the price for acquisitions are frequently requested during a proposal audit. This data may include subcontracts, purchase orders, material orders, and similar source documents. Contractors should become familiar with the thresholds set forth in FAR 15.403-4 related to adequate price competition.

E. Justification of the pricing methods

Contractors should be prepared to provide an explanation of the pricing method for cross-organization transfers. This is particularly important for transfers priced at costs other than the cost of comparable competitive commercial work of the division, subsidiary, or affiliate of the contractor.

F. The basis of the proposed indirect expense

Proposal audits will include analysis of the basis of proposed indirect expenses, and the indirect rate calculations including facilities, overhead, general and administrative, material handling, and fringe benefit rates. The costs associated with indirect expenses is generally a substantial portion of the proposal and is reviewed closely. Support for the expenses should include the current year's complete operating budget and a strategic plan covering the proposed contract period of performance. The operational budget should be at the department/pool level with expense item detail supporting anticipated contract performance. The budget should additionally detail indirect expenses and show the relationship of direct labor, or other allocation base, to sales projections.

G. Other than cost or pricing data

Data requested by DCAA to evaluate information other than cost or pricing data will be based on the assistance requested by the CO and the type of information the contractor has submitted

H. Commercial items

Auditors are sometimes asked to assist the CO in deciding whether an item fulfills the commercial item definition in FAR 2.101 and whether the price is reasonable. Examples of data that may be requested when helping a CO in assessing presented commercial items involve:

1. Source documents supporting sales history, quantities, and prices

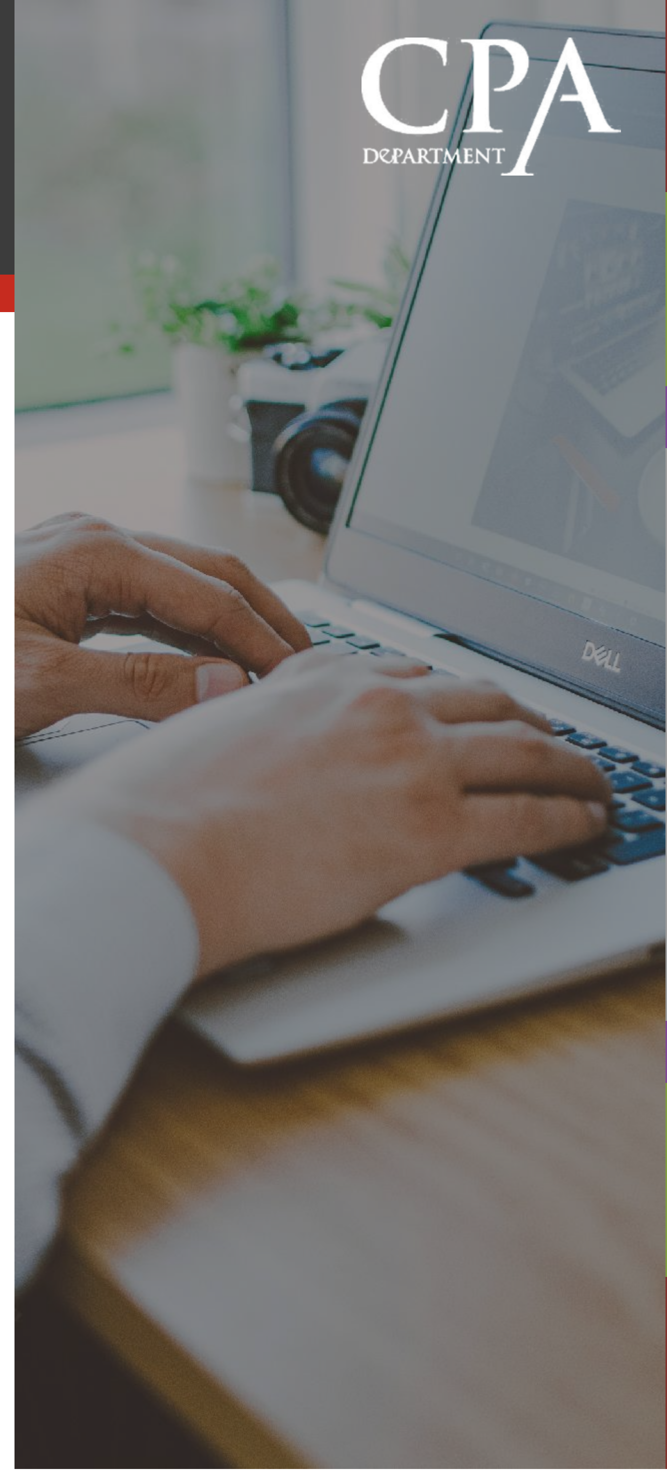
2. Documents identifying special terms and conditions

3. Documents identifying customarily offered discounts for an item

4. Sources of financial data such as surveys and financial studies

5. Catalogs and price lists

6. Historical data for an item previously not determined commercial that the offeror is now trying to qualify as a commercial item



Audit Initiation and Review of Proposal Adequacy

The audit is initiated when the Procuring Contracting Officer (PCO) or the Administrative Contracting Officer (ACO) submits a request to DCAA. The first task an auditor completes is a review of the proposal package for adequacy, in accordance with the instructions in FAR 15.408, or the format specified by the CO.

If the proposal has not been effectively prepared, the auditor will advise the PCO/ACO that the proposal be sent back to the contractor without audit until such time as a satisfactory proposal is received. If the proposal is satisfactory, the auditor will proceed with the audit.

Auditor Requests Supporting Data from the Contractor and Performs Audit

When an auditor requests supporting documentation from a contractor, the request clearly states what support is required and when it must be provided.

Whenever possible, the proposal and supporting data should be provided in an electronic format.

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Exit

Upon completion of the audit, an exit conference will be held to review the results of the audit. However, if exceptions are taken to the proposal, the auditor will not disclose detailed conclusions relative to the reasons or amounts. These results will be provided to the CO for use in the negotiation of proposed costs.

Key Takeaways

Proposal audits are performed to determine whether pricing proposals are adequate and establish a fair and reasonable price for goods and services. Contractors should be prepared to provide adequate details of labor costs, material costs, and subcontractor costs, and should have a well-organized system of price competition.

Public Vouchers Audit

Purpose and Scope

Public Voucher audits are conducted by DCAA to determine the accuracy of costs billed to the government. This type of contract impacts the audit review of public vouchers. Cost-type contracts provide for interim payments of costs. Fixed-price contracts often permit cost-based progress payments. Each of these payment methods is a type of financing arrangement which permits contractors to receive payments prior to full delivery of end products or services, which can take months or even years under a government contract.

Additionally, contractors are frequently permitted to establish provisional indirect cost billing rates. These rates are used for reimbursement of indirect costs either through public vouchers for cost-type contracts or by progress payments for fixed-price contracts. Ultimately, the payment is ‘settled’ and adjusted to actual incurred

rates at the end of the contractor's fiscal year. Billing rates may be prospectively or retroactively revised by mutual agreement to prevent substantial overpayment or underpayment by the government. When the final rates are established, an adjustment is made for any variance between the payments made using provisional rates, and the payments calculated using final rates.

Audit Content

DCAA evaluates public vouchers for compliance with contract terms and billing instructions and reconciles billed costs to the accounting records. Further, DCAA will verify timely payments are being made by the contractor to vendors and subcontractors.

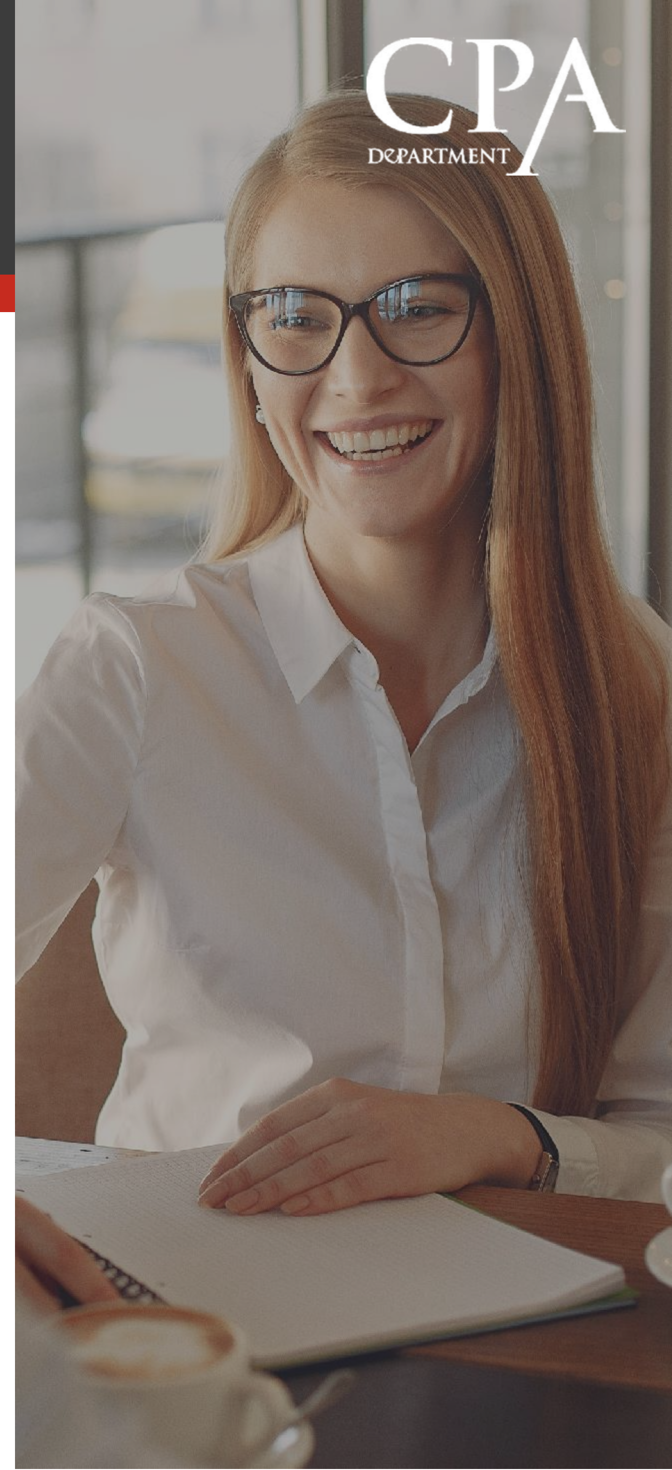
Wide Area Workflow System (now iRapt)

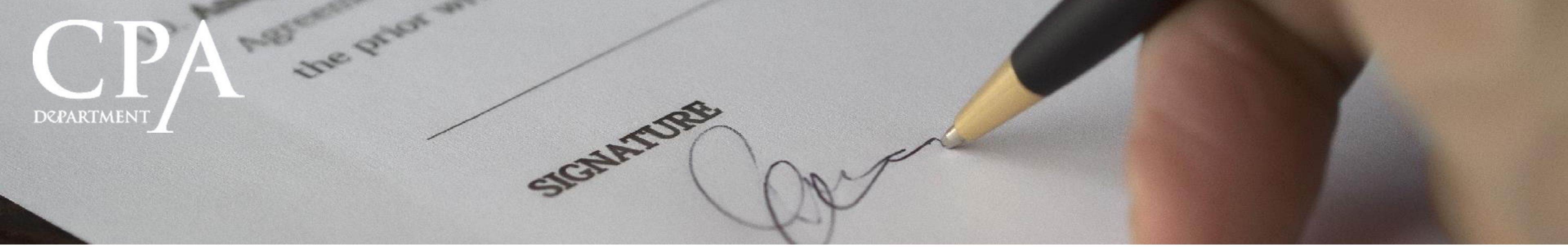
The iRapt system provides a method to electronically process vendor payment requests and collect reports to eradicate paper transactions. Unless contract terms require hard copy vouchers, DCAA directs all contractors to submit their vouchers through iRapt.

Electronic delivery of invoices provides global availability of documents and improved data precision. The electronic nature of the vouchers allows DCAA to randomly and selectively identify vouchers for audit.

Key Takeaways

DCAA performs voucher reviews on selected vouchers based on risk, and always performs a review of the initial voucher under a new contract.





To avoid rejection, contractors should show sufficient support for costs billed and provide complete information that is required by contract terms. Interim vouchers should be calculated directly from cost accounting records and based on established billing rates.

Floor Checks

Purpose and Scope

Floor checks are DCAA's technique for real-time audit testing. They are performed to assess compliance of the contractor's timekeeping strategy, controls on labor charges, and to verify worker time records for reliability and accuracy.

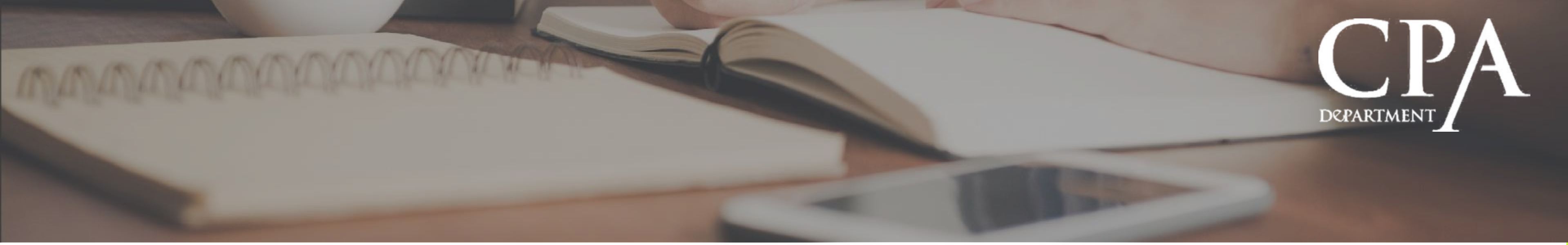
DCAA performs floor checks and labor interviews to mitigate the risk of labor costs being documented or accumulated incorrectly. Hence, the main objectives of floor checks are to ensure that labor costs are precisely and timely identified as either direct or indirect in the accounting system, and posted to the appropriate cost objective.

Audit Content

While materials, other direct costs, and subcontract costs are supported by external third-party documentation, contractor labor is supported solely internally by contractor-created records. This poses a significant risk to the government of a potential mischarge. For this reason, DCAA frequently performs unannounced floor checks to verify proper labor charging, particularly under flexibly priced contracts, which include time and material (T&M), labor hours, and cost-reimbursable contracts.

Contractors are expected to maintain well-detailed policies and practices for timekeeping and ensure workers are charging time daily. The most important component in any sound labor time charging system is the individual employee.

The floor check will focus on the policies, procedures, and internal controls put in place by the contractor.



Segregation of Duties

Auditors will review whether contractors have segregated tasks for labor-related activities. For instance, the responsibility for timekeeping and payroll accounting should generally be separated. In addition, administrators who are responsible for meeting contract budgets should not be allowed to edit employee time charges.

It is acknowledged that for a very small company, this type of segregation may not be possible.

Timekeeping Training

Auditors will inquire about training provided to employees for timekeeping activities. Contractors should emphasize the importance of timesheet preparation in staff meetings, employee training, and the positioning of signs throughout the workplace that remind employees of the importance of accurate and current timesheets. Detailed guidelines for timesheet preparation should be established through a timekeeping instruction manual and company practice. Those directives must suggest that the employee is personally responsible for the following:

1. Recording their time daily
2. Recording time on the timesheet
3. The accurate distribution of time by project, contract name, or another identifier that is for a particular assignment. To ensure accuracy, a listing of charge numbers and their descriptions must be provided to the employee and kept in the work permit system either electronically or in a paper version for the employee to refer to as needed.
4. When changes are made to previously submitted timesheets, procedures should be in place that recognize the original time charge, the corrected time charge, and documentation from the employee indicating their agreement with the change.

5. Recording all hours worked whether paid or not. It is necessary to record every hour worked, referred to as 'total time accounting.' Labor rate calculations and allocations of labor costs must reflect all hours worked in order to accurately charge costs to cost objectives. Unpaid hours worked are termed uncompensated overtime.

6. Certifying the hours on the timesheet reflect the hours worked and the appropriate cost objective at the end of each work period.

Key Takeaways

DCAA performs unannounced floor checks to determine the adequacy and accuracy of the timekeeping system for reimbursement of labor costs under cost reimbursable, time and material (T&M), and labor hour contracts. DCAA auditors periodically perform physical observations of work areas and interviews of employees to determine:

1. Employees are at work.
2. Employees are performing in their assigned job classification.
3. Employee time is charged to the appropriate job or indirect account.

To successfully pass a floor check, contractors must maintain proper timekeeping policies and procedures and vigilantly monitor employee compliance.

Provisional Billing Rate Audit

Provisional billing rates are the expected indirect rates a company estimates for the upcoming year. These projected rates are used to calculate interim billings submitted to the government during the year. The audit of the projected rates is known as a provisional billing rate audit.

Purpose and Scope

Provisional Billing Rates audits are designed to confirm the contractor's estimate of its billing rates, which is employed for interim purposes until actual and final indirect rates for the contractor's fiscal year are determined. FAR 42.704 provides practices and guidance for establishing PBRs.

The government allows interim payments if authorized by the contract during contract performance by progress payments for fixed-price contracts, or by public voucher for cost-type contracts. Reimbursement of indirect costs for these payments is generally made through billing rates that are established to approximately equal the expected final indirect cost rates for the contractor's fiscal period.

Billing rates may be prospectively or retroactively revised by mutual agreement, at either the government's or contractor's request, to prevent substantial overpayment or underpayment. Once the final rates are established, an adjustment is made for any variance between the billing and final rates.

Audit Content

Provisional billing rates should be submitted by the contractor before the beginning of the fiscal year and after budgets are completed. The PBRs represent a 12-month term aligned with the contractor's fiscal year. Vouchers and progress payments may be returned if submitted without properly established billing rates.

1. Proposed billing rate calculations (Pool and Base) with a brief justification.
2. Prior fiscal year (FY) pool and base.
3. Current Fiscal Year to date pool and base.
4. Current Fiscal Year budget pool and base, if available.
5. Comparative analysis with an explanation of any significant differences.

Key Takeaways

Provisional Billing Rates audits are performed to verify the estimate of the contractor's final year-end rates to ensure interim billing is as accurate as possible.

If billed costs exceed claimed costs, the contractor must appropriately adjust the next voucher or remit or otherwise credit the government for the difference.

Incurred Cost Audits

Purpose

Incurred Cost audits are designed to determine if costs charged to auditable government contracts are allowable, allocable, and reasonable in accordance with contract terms, generally accepted accounting principles, cost accounting standards, and applicable government acquisition regulations.

Scope

Incurred Cost audits are one of the most important Post-Award Audits, verifying contractor direct and indirect costs incurred and intended to recover unallowed or unreasonable costs charged to the government.

Incurred Cost Proposals

An Incurred Cost Proposal (ICP) is an annual submission reporting the actual expenses incurred by a contractor performing on a cost-reimbursable contract. The proposal identifies actual direct and indirect expenses and calculates actual indirect rates. The auditor then compares these actual contract costs to those billed using provisional billing rates.

Due to a current backlog of Incurred Cost audits, DCAA is using a tiered risk methodology to select Incurred Cost Proposals for audit. When annual auditable costs are less than $1 million, then the contract will not be selected for audit unless it meets an exception. For instance, an Incurred Cost Proposal may be selected for audit even though costs are less than $1 million if the government has concerns related to a recent accounting system audit performed on the contractor.

Incurred Cost Proposals including costs of more than $1 million annually are placed in a higher risk pool. These risk pool tiers change from time to time, as do the sample selection sizes for audit.

Audit Content

Following receipt of an adequate proposal, the auditor will review the proposal for adequacy. If the proposal is considered inadequate, the auditor will inform the contractor and CO in writing of the deficiency as required by FAR 42.705-1(b)(iii)(A) and the proposal will not be accepted until the deficiency is corrected. If the proposal is considered adequate, the auditor will conduct an evaluation of both direct and indirect costs reported.

The audit objective is to examine contractor cost representations identified in the Incurred Cost Proposal to determine whether such costs are reasonable, allowable, and allocable to the contract(s), in accordance with Generally Accepted Accounting Principles (GAAP) and Cost Accounting Standards (CAS), and not prohibited by the contract, government statute, or regulation (FAR part 31). During the audit, the auditor will discuss audit findings with the contractor as they arise.

After completing the audit, the auditor will provide the contractor with the results of the audit in writing and seek the contractor's agreement. Since significant audit findings have been discussed during the audit process, this exit conference is merely a summary of issues and resolutions. The contractor will be given the chance to respond to the audit findings and any contractor comments will be included in the final report.

The auditor will evaluate compliance with the following requirements during the audit:

- **<u>All services are identified to a final cost objective</u>**

  Costs must be accumulated by contract at a similar level used for billing costs (e.g., by delivery order) to determine their allowability.

- **<u>Direct costs segregated from indirect costs</u>**

  Costs identified specifically with a contract are direct costs of the contract and are to be charged directly to the contract. All costs specifically identified with other final cost objectives of the contractor are direct costs of those cost objectives.

  No final cost objectives shall have been allocated to it as a direct cost if other costs incurred for the same purpose in like circumstances have been included in any indirect cost pool to be allocated to that or any other final cost objective.

- **Accounting for subcontract costs**

The responsibility of the contractor for managing its subcontracts is stated in FAR 42.202(e)(2). The prime contractor is mainly responsible for subcontract award, technical and financial performance monitoring, ensuring that indirect rate proposals and annual rate adjustments are submitted on a timely basis, and payment to the subcontractor for the work accomplished under subcontract terms.

- **Effective evaluation of changes**

FAR 31.203 (e) states: "The method of allocating indirect costs may require revision when there is a significant change in the nature of the business, the extent of subcontracting, fixed-asset im-improvement programs, inventories, the volume of sales and production, manufacturing processes, the contractor's products or other relevant circumstances." Contractors should consider pursuing an advance agreement with the CO when changing allocation methods.

- **Separate and well-allocated overhead pools maintained**

A very small contractor may have only one overhead pool. However, for larger contractors, it is common to have separate overhead pools for engineering, manufacturing, material handling, and off-site activities.

Key Takeaways

Contractors are advised to monitor and manage their actual and provisional rates throughout the fiscal year to ensure that billing is as accurate as possible.

Key actions that will help the incurred cost audit process go smoothly and quickly include the following:

1. Self-evaluation of the adequacy of the proposal
2. Ensuring all services are identified to a final cost objective
3. Ensuring direct costs have been properly segregated from indirect costs
4. Fulfilling all the responsibilities required for subcontracts
5. Determining if multiple overhead cost pools are appropriate

Contract Closeout Audits

Purpose and Scope

A Contract Closeout audit occurs when a contract has been fulfilled, all executive, administrative, and governmental actions have been finalized, all disputes have been resolved, and final payments have been received. These audits are important to the government because they support the settlement of government financial records.

A contract closeout checklist is used by DCAA auditors to ensure all closeout actions have been satisfactorily accomplished.

Audit Content

Federal Acquisition Regulation (FAR) mandated timelines require contracts to be closed within 6 months to 36 months after contract completion. Cost-type contracts are closed within 36 months, fixed-price contracts within 6 months, and all other contracts within 20 months. A quick closeout may be permitted if the contract value is under $1 million.

The contract administration office is responsible for initiating administrative closeout of the contract after receiving evidence of its physical completion. At the outset of this process, the contract administration office reviews the contract funds status and notifies the contracting officer of any excess funds the contract administration office might deobligate. When complete, the administrative closeout procedures must ensure the following:

1. The disposition of classified material is completed.
2. The final patent report is cleared.
3. The final royalty report is cleared.
4. There is no outstanding value engineering change proposal.

Audit Content

5. Plant clearance report is received.
6. Property clearance is received.
7. All interim or disallowed costs are settled.
8. A price revision is completed.
9. Subcontracts are settled by the prime contractor.
10. Prior year indirect cost rates are settled.
11. Termination docket is completed.
12. Contract audit is completed.
13. The contractor's closing statement is completed.
14. The contractor's final invoice has been submitted.
15. Contract funds review is completed and excess funds deobligated.

Key Takeaways

Maintaining timely and adequate Incurred Cost Submissions, good records and IT backups is very important for efficient contract closeouts. The government cannot be relied upon to keep good records.

Conclusion

Government contractors, and aspiring government contractors, operate in an environment much more regulated than commercial entities. Obtaining an understanding of FAR and DFARS is important to successfully navigating the compliance required of government contractors and avoiding costly mistakes. While mastering FAR and DFARS can take some time, contractors are encouraged to develop an understanding of these commonly performed audits. Establishing systems, policies, and procedures to ensure these audits – when performed – are successfully passed, will establish a strong base and structure for remaining compliant with regulations while performing on government contracts. This will reduce liability and ensure the business is putting forth a good faith effort to do business successfully with the government. As contractors grow, additional requirements are imposed in the form of Cost Accounting Standards and Disclosure Statements. These standards impose Business System requirements, which are much broader and more encompassing than the audits described here. They will be addressed as a separate topic.

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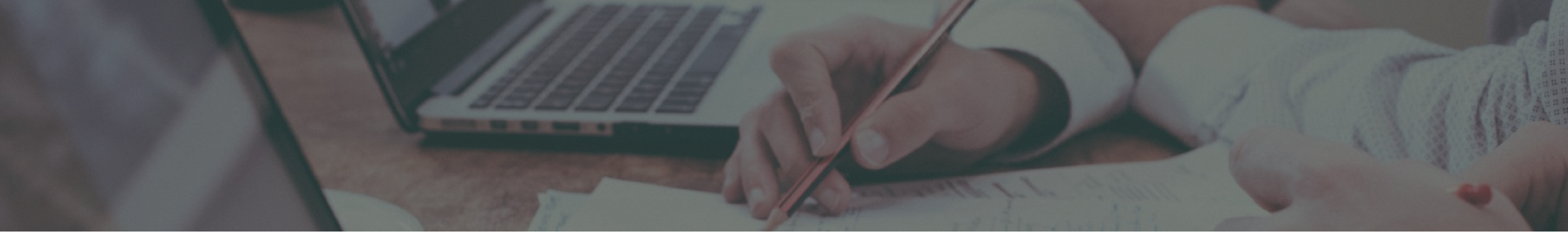

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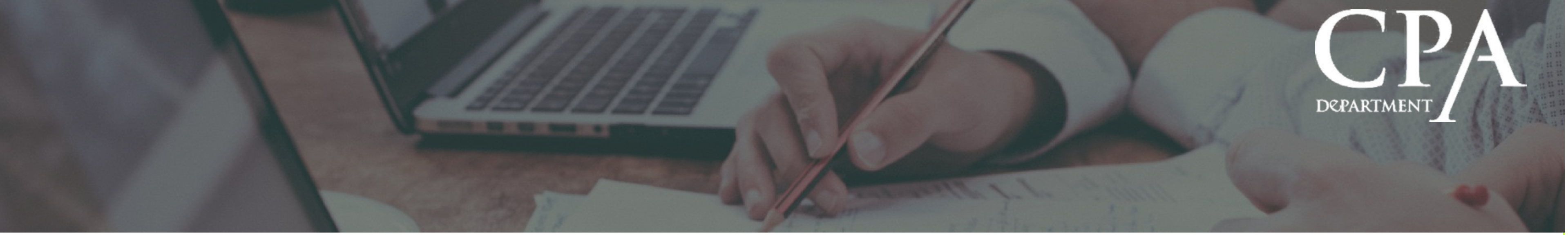

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