

DCAA Audit Insights: Navigating DCAA Audit Issues: Insights into Incurred Cost Proposal Trends and Best Practices

Brad Tress, June 13, 2024



DCAA Audit Insights

June 4th - How to Navigate Audit Challenges: Unravelling the Complexities

June 13th – Navigating DCAA Audit Issues: Insights into Incurred Cost Proposal Trends and Best Practices

June 20th – What is a Business System and why does DCAA care?

June 27th - Understanding the Issues and Challenges of DCAA's “Other” Audits?



Agenda for today:

- Background
- High Level Statistics
- Trending Questioned Costs
- Mitigation Best Practices

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Background



Quick Background

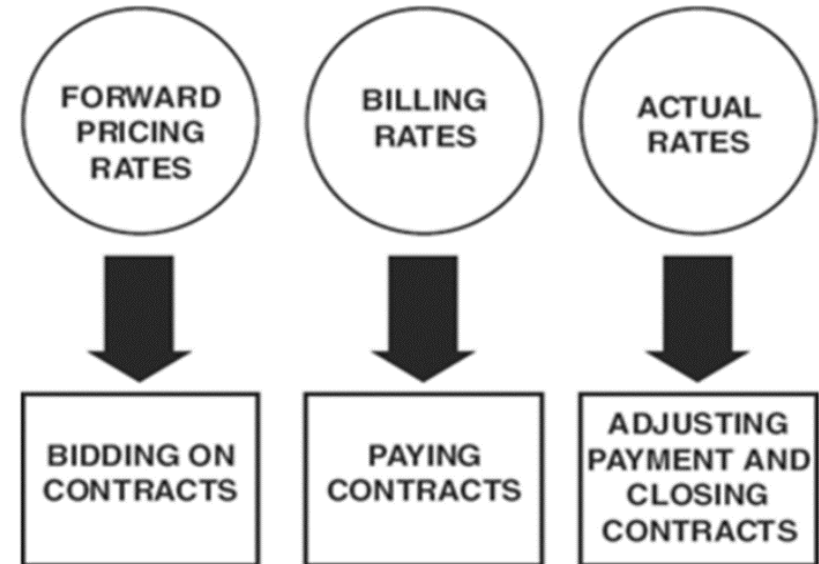
- What is an ICP?
- Who submits an ICP?
- Why must I submit an ICP?
- What types of contracts are impacted?
- When is it audited?
- Is it always audited?

ICP Evaluation Timeline

1. Contractor proposal of ICP
2. DCAA performs adequacy check
3. DCAA informs contractor of ICP adequacy or inadequacy (60 Days)
 - In the event of an inadequate proposal the Contractor may correct and resubmit
4. DCAA risk assessment and audit selection (1 Year)
 - ICP is selected for audit OR
 - ICP is dispositioned with a memorandum to the CO

The ICP and the Indirect Rate Cycle

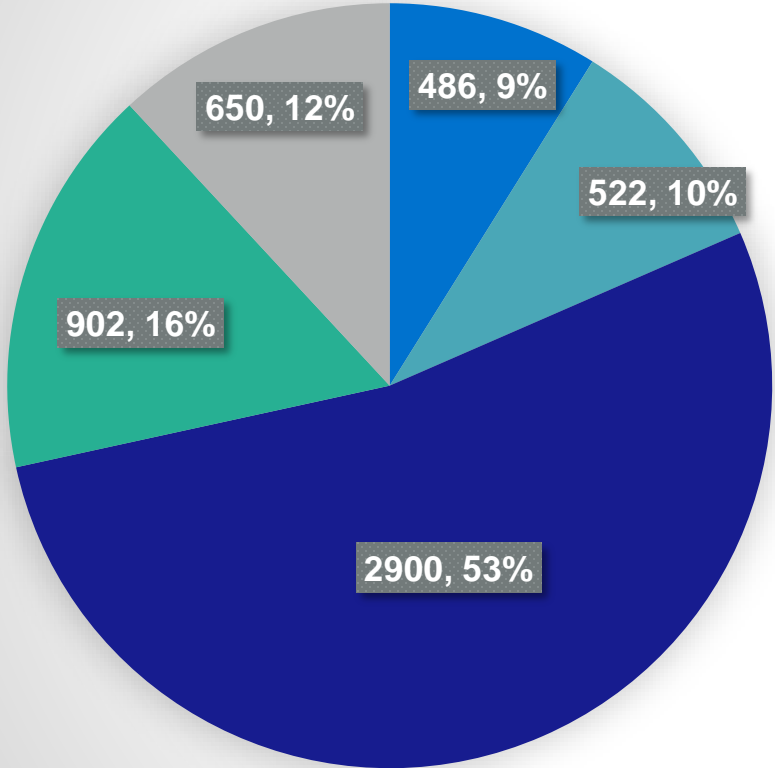
- An ICP is a contractor proposal to the government to “true-up” provisional rates to actual rates as a part of the indirect rate cycle
- Contractor indirect rate cycle
 - Bid and bill with forward pricing rates
 - Monitor the forward pricing rates versus actual rates periodically
 - Compare the rates at the end of year, at ICP submittal, and when the ICP is settled
 - Submit revised rates if there is a material difference throughout contract
 - Submit final rates in ICP
 - Settle final rates at contract closeout
- ICP rates are comprised of costs which are allocable, reasonable and allowable on government contracts



High Level Statistics

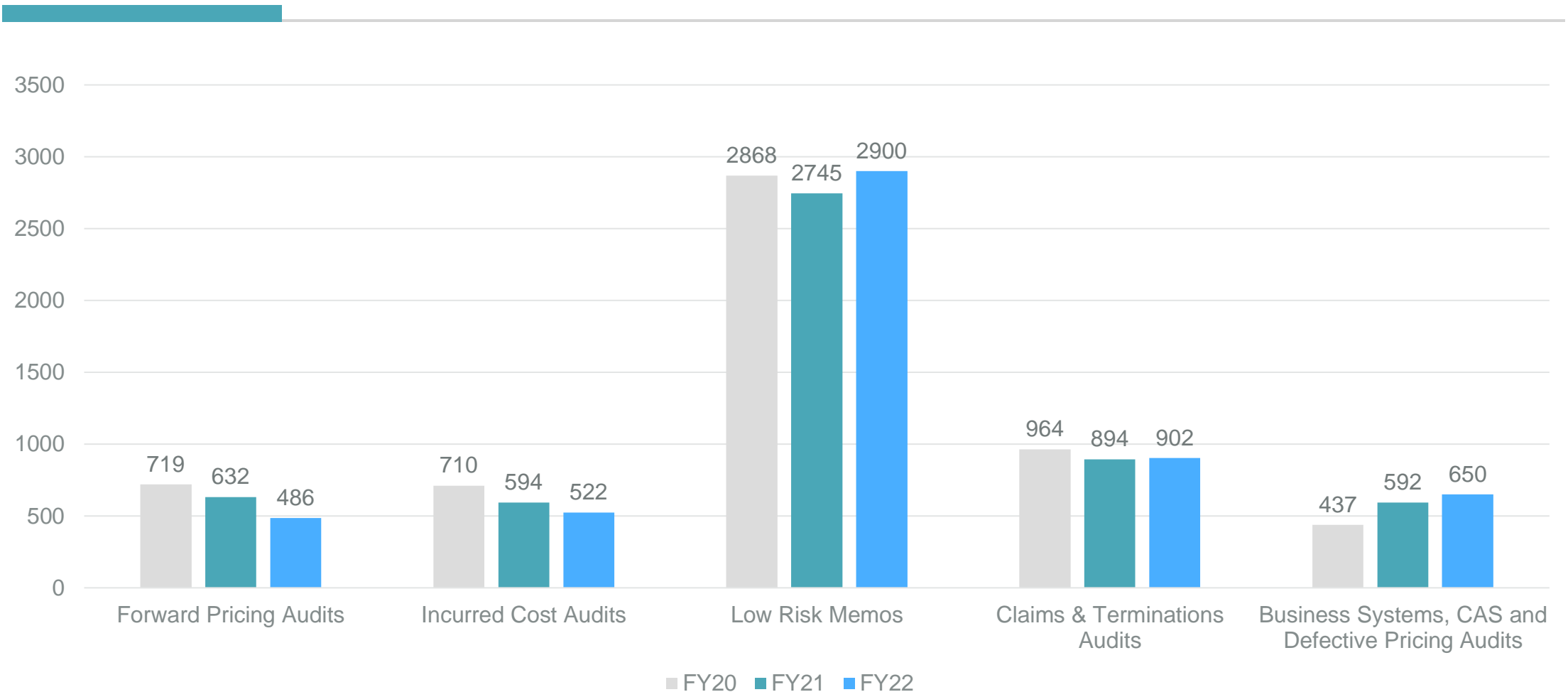
FY22 High Priority Audits

DCAA's FY22 High-Priority Audits



- Forward Pricing Audits
- Incurring Cost Audits
- Low Risk Memos (Not Audited)
- Claims & Terminations Audits
- Business Systems, CAS and Defective Pricing Audits

DCAA Audit Reports FY20-22



Net Savings and ROI

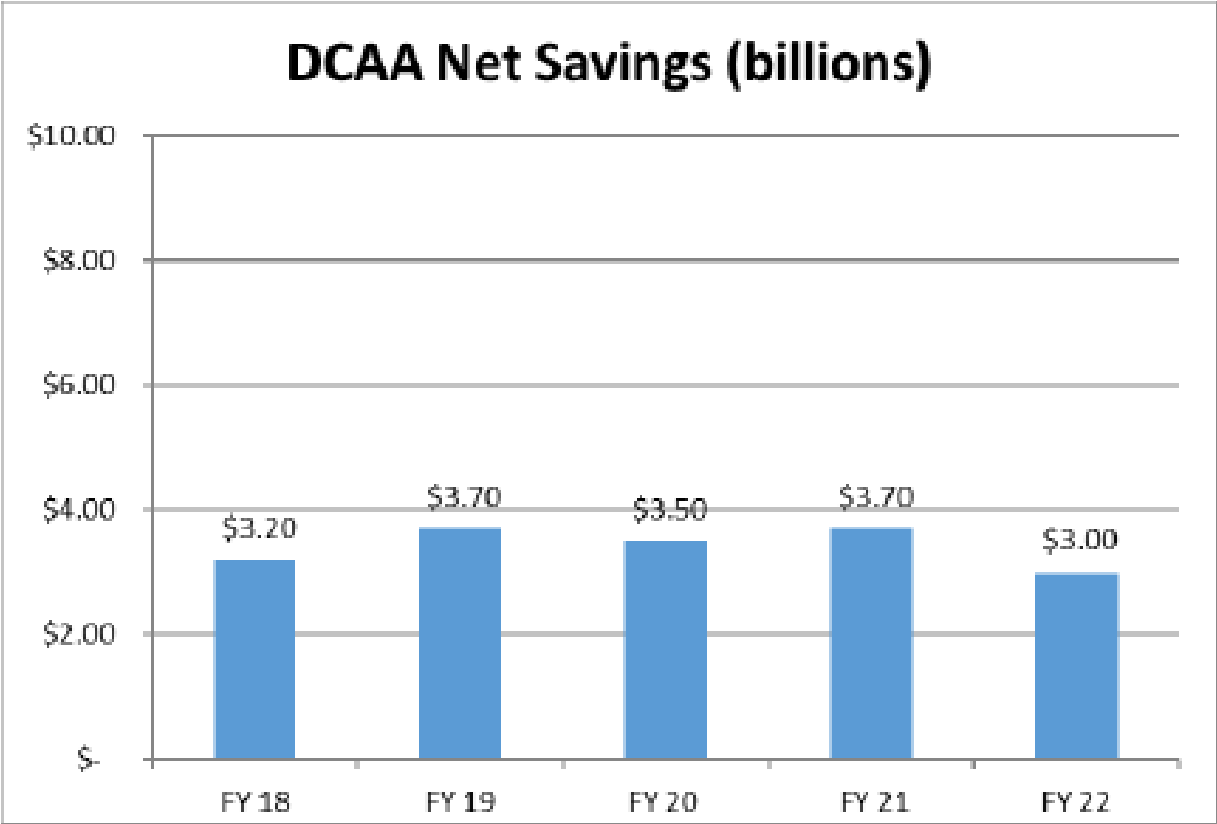


Figure 1 – DCAA Net Savings (in billions)

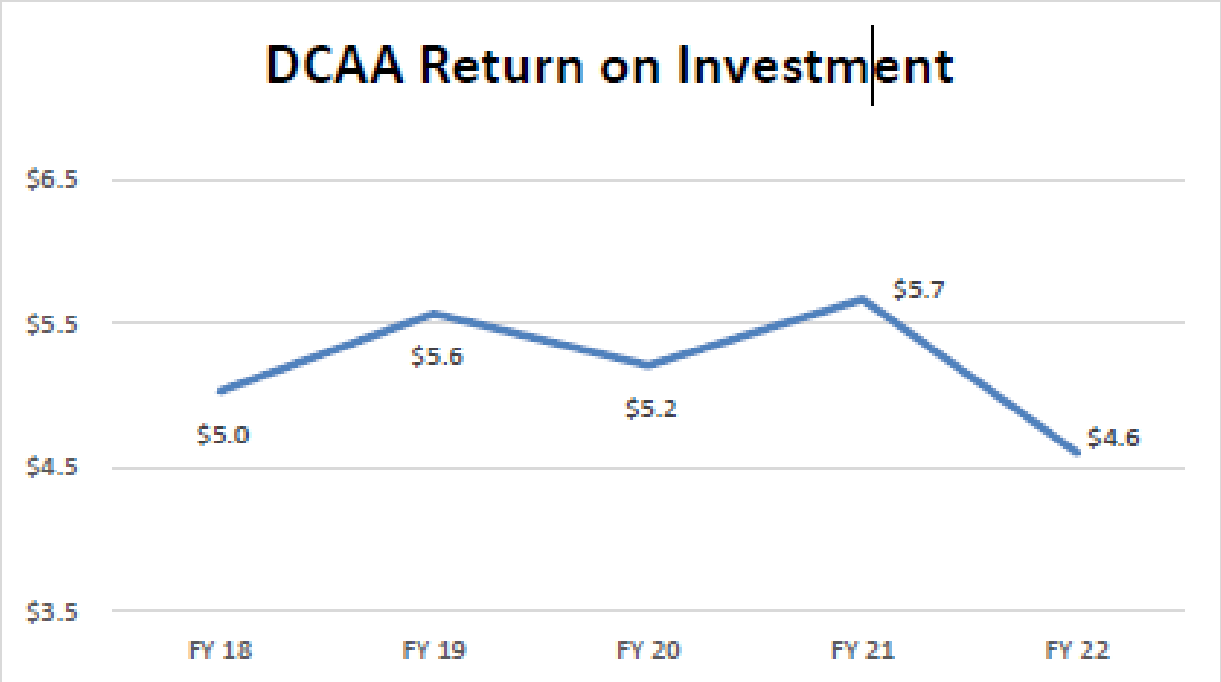


Figure 2 – DCAA Return on Investment

Audit Highlights

- 522 audit reports issued in FY22
 - 405 by DCAA
 - 117 by IPAs
- Third straight year that the number of DCAA issued incurred cost audit reports has declined
 - Down 53% from FY19
- 85% of submitted ICPs receive low-risk memo
- 26.2% sustainment rate on exceptions

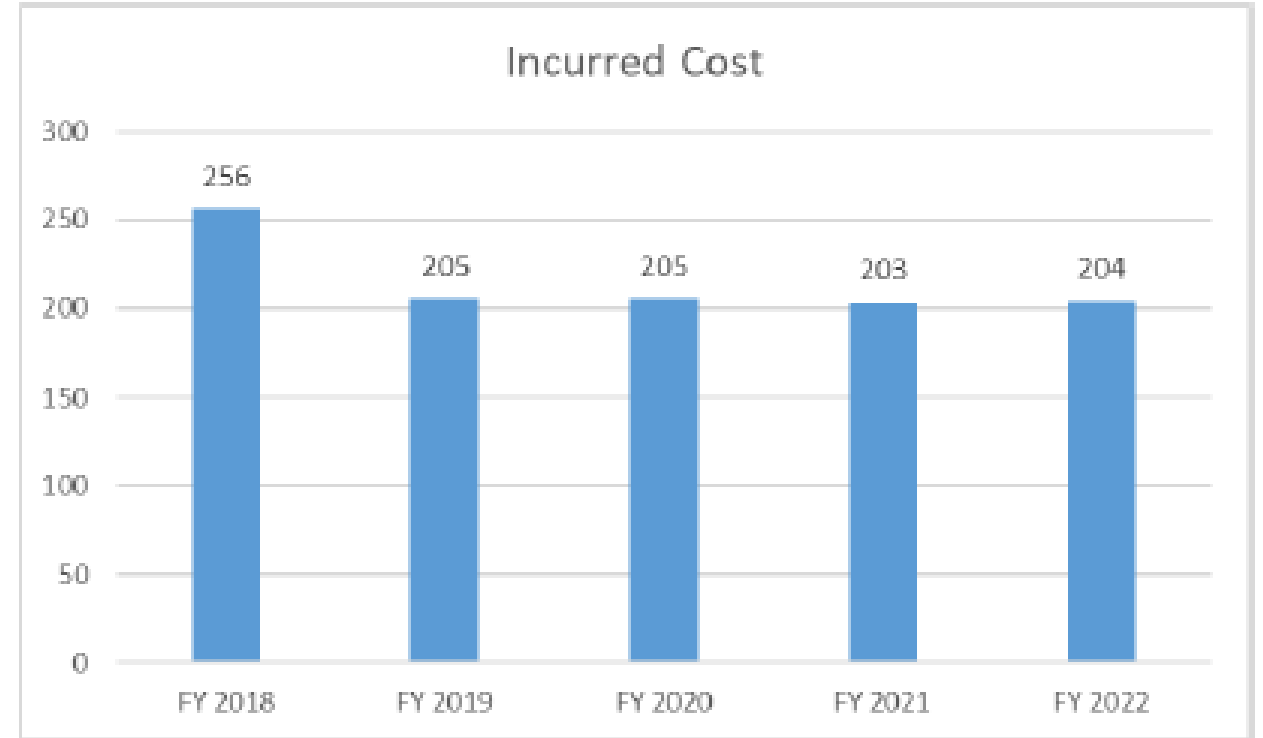
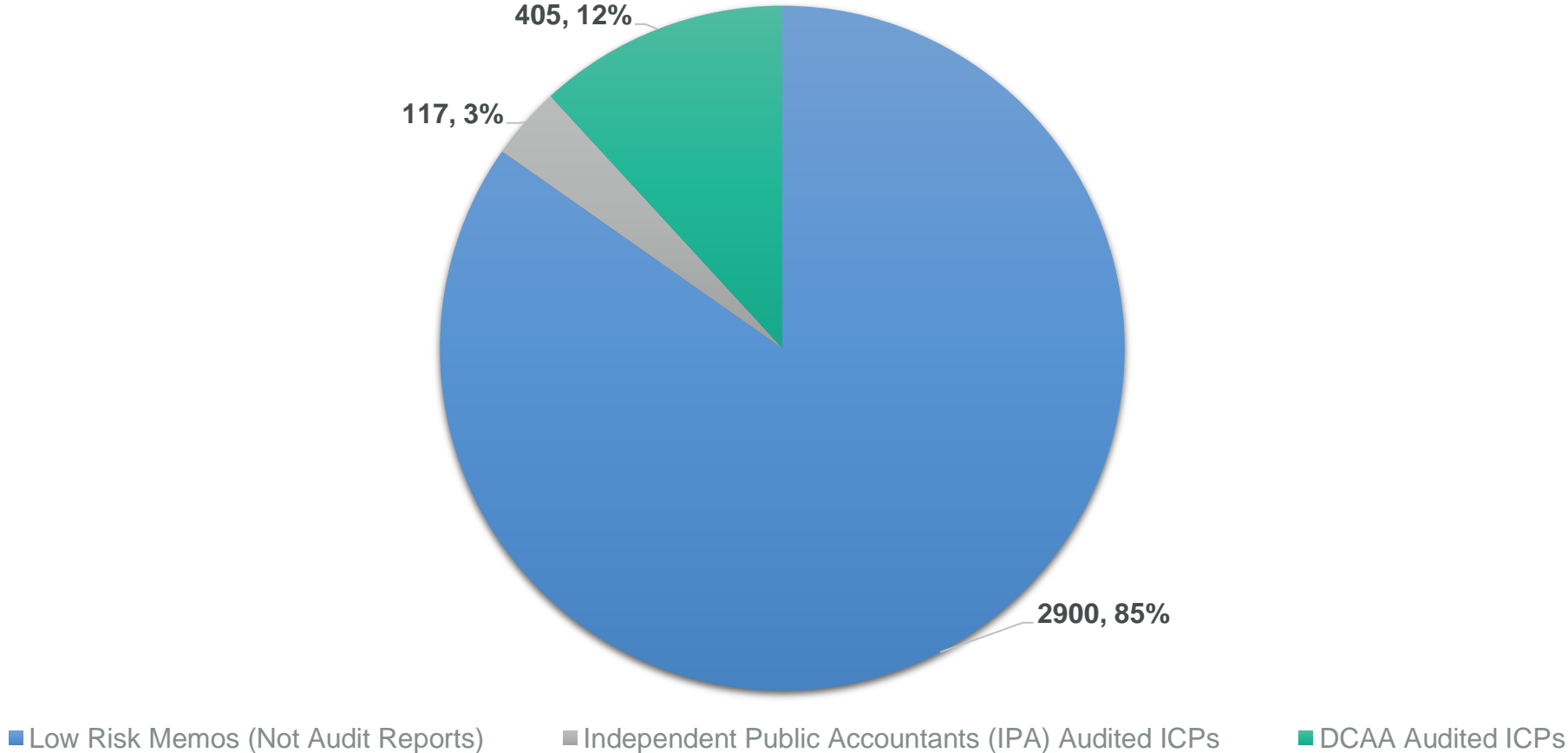


Figure 5 – Incurred Cost average elapsed days

Audit Highlights (Cont'd)

DCAA's FY22 Incurred Cost Proposal Audit Report Efforts



Trending Questioned Costs

Directly Associated Costs – FAR 31.201-6

- A cost which is generated solely as a result of the incurrence of another cost, and which would not have been incurred had the other cost not been incurred
- When an unallowable cost is incurred, its directly associated costs are also unallowable
 - Example: Salary expenses of employees who participate in unallowable activities
 - Generally, salary and travel expenses
- Raytheon decision makes these potentially “expressly unallowable”

Commercial Selling Costs

- Recent Booz Allen Settlement
- Potential difficulty in ascertaining benefits of administrative costs
- Downstream impacts on contractors
- Handling employee concerns

IR&D and B&P Costs – FAR 31.205-18

- Allowable if reasonable
- Indirect people continue to charge indirect, direct people charge IR&D and B&P projects
- R&D incurred in performance of a contract is a direct cost
 - Costs in excess of contract price are unallowable
- B&P preparing and supporting bids

Professional and Consultant Service Costs – FAR 31.205-33

- Generally allowable but must be reasonable
- Cannot be officers or employees of the contractor
- Must be supported by:
 1. Details of agreement and actual services
 2. Invoices with sufficient detail to allow an evaluation of what was done
 3. Work product or memorandum of meetings

Legal Costs – FAR 31.205-47

- Costs are unallowable if in connection with violation of or failure to comply with laws and regulations (admitted wrongdoing)
- Other Key Unallowables:
 - Bid Protests
 - M&A / Organizational costs
 - Legal costs related to JV or teaming arrangement disputes
- Other legal costs are generally allowable, but auditors will be asking for the 3 items required for professional and consultant services
- Settlement costs generally allowable provided that there is no admitted wrongdoing and very little likelihood complaint would have been successful on the merits
 - However, there is high risk DCAA questions it

Rental Costs – FAR 31.205-36

- Real or personal property operating leases
- Must be reasonable
- Related parties limited to cost of ownership unless personal property and established practices similar to unaffiliated lessees

Compensation – FAR 31.205-6

- Most commonly questioned cost
- Generally biggest “bang for auditor buck”
- Compensation for personal services must be:
 - for work performed by the employee in the current year;
 - reasonable for the work performed; and
 - based upon and conform to the terms and conditions of the contractor’s established compensation plan or practice followed so consistently as to imply, in effect, an agreement to make the payment.

Compensation – FAR 31.205-6

- There is special consideration for:
 - Owners of closely held corporations, members of limited liability companies, partners, sole proprietors, or members of their immediate families; and
 - Persons who are contractually committed to acquire a substantial financial interest in the contractor's enterprise.
- For these individuals, compensation must be:
 - Reasonable for the personal services rendered; and
 - NOT be a distribution of profits (which is not an allowable contract cost).

Compensation – FAR 31.205-6

- Allowable compensation must be reasonable for work performed based on comparisons to:
 - Firms of the same size
 - Firms in the same industry
 - Firms in the same geographic area
 - Firms engaged in non-government work

Bonuses and Incentive Compensation

- Allowable provided:
 - Awards are paid or accrued under an agreement entered into in good faith between the contractor and the employees before the services are rendered or pursuant to an established plan or policy followed by the contractor so consistently as to imply, in effect, an agreement to make such payment; and
- Basis for the award is supported.
 - Metrics?

Compensation Challenges

- Reasonableness
 - Statutory limit (\$646k for 2024)
 - Reasonable for work performed
- Bonuses
- Lack of wage or salary survey support
- Inconsistency
- T&M contracts – resume and labor category requirements

DCAA Example

EXECUTIVE COMPENSATION REVIEW FOR CALENDAR YEARS 2010 THROUGH 2012

Sales	Executive	Claimed Cash Comp (1)	Survey Cash Compensation Results (2)				Survey Avg. + 10% ROR Cash Comp.	Total Unreasonable
			Towers Watson	ERI	HRA	Mercer		
	CY 2010							
\$16.0M	President	\$ 408,489	\$ 219,941	\$ 219,036	\$ 209,156	\$ 253,457	\$ 247,937	\$ 160,552
	CEO	468,140	288,378	319,724	259,374	341,566	332,487	135,653
	VP of A	325,387	ND	169,592	ND	196,272	201,225	124,162
	VP of B	325,234	ND	152,920	ND	162,728	173,606	151,628
	SR Analyst	232,316	ND	ND	ND	ND		
							Subtotal:	\$ 571,995
	CY 2011							
\$18.0M	President	\$ 457,863	\$ 227,963	\$ 219,844	\$ 214,708	\$ 263,056	\$ 254,532	\$ 203,331
	Director	529,097	300,519	315,966	266,259	355,554	340,532	188,565
	VP of A	342,544	ND	174,930	ND	218,277	216,264	126,280
	VP of B	348,306	ND	148,117	ND	159,299	169,079	179,227
	SR Analyst	231,260	ND	ND	ND	ND		
							Subtotal:	\$ 697,403
	CY 2012							
\$12.0M	President	\$ 429,698	\$ 218,036	\$ 201,387	\$ 220,720	ND	\$ 234,719	\$ 194,979
	Director	486,958	275,937	275,555	273,714	ND	302,576	184,382
	VP of A	316,340	ND	179,537	ND	ND	197,491	118,849
	VP of B	331,239	ND	149,948	ND	ND	164,943	166,296
	PM	173,428	ND	ND	156,423	ND	172,065	1,363
							Subtotal:	\$ 665,869
								\$ 1,935,267

Case Law Background

- Techplan (1996)
 - Established general steps a compensation expert would use
- Metron (2012)
 - DCAA's salary surveys not calibrated correctly
 - Job titles and responsibilities not mapped correctly
 - 75th percentile reasonable (PhDs and TS/SCI clearances)
- JF Taylor (2013)
 - 10% range of reasonableness called into question
 - DCAA methodology “fatally flawed statistically”
 - “No substance behind the scientific veneer”

Mitigation Best Practices

Contractor Compensation Best Practices

- Be proactive and demonstrate reasonableness according to the case law and DCAM guidance.
- DCAA may not follow these steps but you can!
 - Perform and document your market research with relevant surveys (ERI, BLS etc.) and retain the documentation!
 - If compensation is later questioned, request the basis of the questioned costs including survey results and calculations and evaluate the findings based on the case law and audit guidance.

Set Yourself Up for Success

- Be Low Risk
- Clearly segregate unallowable cost accounts in the chart of accounts and shown them in the ICP as adjusted out of the claimed pool expenses
- Ideally screen for unallowable costs at the point of entry
- Clear and concise policies and procedures for key government contracting areas
 - Direct vs. Indirect
 - Unallowable Costs
 - Timekeeping
 - Indirect Rates
 - Etc.

Audit Walk-throughs and Information Requests

- Government auditors appear to be increasingly requiring audit subject matter demonstration or walk-throughs after the entrance conference
- Additionally, their information requests are increasingly requiring contractors to prepare materials and summaries in support of audit information requests
 - This appears to be a practice of having the contractor prepare the auditor's required audit work papers
 - For example, contractor preparation of a description of its accounting system or specific process area rather than auditor preparation of summaries based upon their audit interviews and findings
 - While this may increase your workload required to support an audit, it also gives you increased control over the information provided and placed in the audit file and improve its accuracy

Communication is Key

- Assign an audit liaison to centralize communication with the government
- Create a secure link or portal transfer if DCAA amenable
 - This ensures no miscommunication on what was sent.
 - Follow up with email confirming receipt
- Be accommodating, but know where to draw the line
 - Some requests may be extraneous but low risk
 - Others better to not allow a potential rabbit hole
 - In gray areas, ask “Why”

At the Time of Audit

- Compile the audit package and have the backup data available in hard copy and electronic format
- Establish that single point of contact for all communication and flow of documentation with the auditor
- Request and push for a timeline as part of your entrance conference
- Request and be prepared to give a detailed walkthrough of your ICP and parts of your accounting system
- Conduct periodic updates on the progress of the audit and any open items.
- Be familiar with DCAA Audit procedures
 - DCAA ICP Audit Program
 - Contract Audit Manual (CAM) Chapter 6 ICP Audit Procedures

At the Time of Audit (Cont'd)

- Continually ask about current findings
- Any time there is a finding ask for a walkthrough of the issue so that you can search for additional documentation
- Request draft audit report prior to exit conference
- Push back on unrealistic timelines for documentation requests, responses, etc.

When Encountering Questioned Costs

- Do not accept precedent setting questioned costs
- Remember that the DCAA is not your customer!
- Ensure your point of view is formally documented in the audit report
- If DCAA is not reasonable present your case to the ACO
- Fight back and urge the ACO not to rubber stamp DCAA findings

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