Policy and Oversight

Contract Audit Directorate

Evaluation of Defense Contract Audit Agency Sampling Initiative of Incurred Cost Proposals on Low-Risk Contractors

Report Number PO 97-032

June 27, 1997

Office of the Inspector General
Department of Defense

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Acronyms

ADV	Annual Dollar Volume
CAS	Cost Accounting Standard
DCAA	Defense Contract Audit Agency
FAOs	Field Audit Offices
FAR	Federal Acquisition Regulation

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

Report No. PO 97-032 June 27, 1997

MEMORANDUM FOR DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY

SUBJECT: Evaluation of Defense Contract Audit Agency Sampling Initiative of Incurred Cost Proposals on Low-Risk Contractors (Project No. 6OC-9035)

Introduction

We are providing this report for review and comment on the Defense Contract Audit Agency (DCAA) sampling initiative of incurred cost proposals on low-risk contractors with annual dollar volume (ADV) of $5 million or less.

Evaluation Results

The Defense Contract Audit Agency effectively implemented the sampling initiative of incurred cost proposals for low-risk contractors with ADV of $5 million or less. Therefore, Audit Policy Memorandum Number 5 will be revised to allow for the sampling plan. However, DCAA subsequently issued revised guidance that, significantly departed from the plan we reviewed and is not supported. Hence, the new DCAA procedures are in noncompliance with Audit Policy Memorandum Number 5 (as revised) and should be rescinded. We have one recommendation to reduce the risk associated with not detecting unallowable costs when performing a desk review as part of the sampling initiative. To protect the Government's interest in those years closed by desk-review procedures, we recommend that the contractor's annual indirect rate agreement letter alert the contractor that prior years' costs may be recovered if expressly unallowable costs are found in a subsequent year's audit. Expressly unallowable costs are costs that are specifically stated as unallowable by law, regulation, or contract. The contractor must certify, under penalty of perjury, that its proposal does not include expressly unallowable costs.

Evaluation Objectives

The objective of our review was to determine the acceptability of the DCAA sampling initiative of incurred cost proposals for low-risk contractors with ADV of $5 million or less. Contractors are required to make annual submissions of the cost incurred on their cost-reimbursable contracts for DCAA audit or review. We performed our evaluation in two phases. We assessed the DCAA test results of sampling low-risk incurred cost proposals for audit and the adequacy of the audits. After evaluating the test results, Headquarters, DCAA, implemented guidance on the sampling initiative and desk-review procedures. In the second phase, we assessed the implementation of the guidance concerning the selection of proposals and the desk-review procedures used to close low-risk incurred cost proposals not selected for audit.

Scope and Methodology

We conducted the evaluation from March 1995 through September 1996. We evaluated the effectiveness of the sampling initiative the DCAA proposed by evaluating:

o the results of the test sampling initiative,

o the adequacy of the incurred cost audits performed,

o the adequacy of the audit guidance implementing the sampling initiative, and

o the adequacy of implementation of the audit guidance for selecting proposals and performing desk reviews.

Enclosure 2 lists the DCAA field offices visited or contacted.

Prior Evaluations

Since January 1985, the Office of Inspector General, DoD, completed three reviews of nonmajor incurred cost audits that directly related to our evaluation. Enclosure 1 discusses the three prior evaluation reports.

Background

In the early 1980s, DCAA was unable to keep pace with the workload in auditing incurred costs on flexibly priced contracts because it lacked audit resources to keep pace with the large procurement buildup. As a result, an extremely large backlog of incurred cost audits developed.

Concern increased over controlling the backlog and reducing it to a reasonable level, approximately 1 year of audit effort ($74 billion). More auditors could have been hired to perform incurred cost audits, but, due to budget constraints, the DCAA staffing levels declined after 1989.

The DCAA made a commitment to the Comptroller of the Department of Defense to reduce the backlog of incurred cost audits to the equivalent of 1 year of contractor's incurred costs or approximately $74 billion by the end of FY 1997. The Comptroller went on record with Congress; the General Accounting Office; the Inspector General, DoD; and industry that the backlog would be reduced despite reductions in DCAA staffing. One DCAA proposal to accomplish this commitment was to sample incurred cost proposals on low-risk contractors with less than $5 million in ADV.

Discussion

Incurred Cost Audits. Federal Acquisition Regulation (FAR) 42.703-2 requires a contractor, within 90 days after the end of its fiscal year, to submit a final indirect cost rate proposal for audit. FAR 42.705-2, Auditor Determination Procedure, designates the cognizant Government Auditor with the responsibility to establish final indirect cost rates for contractors not covered by contracting officer determination. The majority of small contractors are under auditor determination procedures. Contractors are required by Cost Accounting Standard (CAS) 405, Accounting for Unallowable Costs, and the FAR to have policies and procedures to identify and exclude unallowable costs.

Cost Accounting Standards. Generally the less than $5 million ADV contractors are under Modified CAS coverage that requires compliance with CASs 401, 402, 405, and 406. CAS 405, Accounting for Unallowable Costs, states that costs expressly unallowable or mutually agreed to be unallowable, including costs mutually agreed to be unallowable directly associated costs, shall be identified and excluded from any billing, claim, or proposal applicable to a Government contract. An expressly unallowable cost is that which is specifically stated to be unallowable by law, regulation, or contract.

FAR Appendix B, 9903.201-4, Contract Clauses, requires the contracting officer to insert the clause, Disclosure and Consistency of Cost Accounting Practices, in negotiated contracts when the contract amount is more than $500,000 but less than $25 million and the offeror certifies it is eligible for and elects to use modified CAS Coverage. The clause states in (a)(4):

> Agree to an adjustment of the contract price or cost allowance, as appropriate, if the Contractor or a subcontractor fails to comply with the applicable CAS or to follow any cost accounting practice, and such failure results in any increased costs paid by the United States. Such adjustment shall provide for recovery of the increased costs to the United States together with interest thereon computed at the annual rate of interest established under the Internal Revenue Code of 1986 (26 U.S.C. 6621), from the time the payment by the United States was made to the time the adjustment is effected.

Certification Requirements. In accordance with United States Code, Title 10, Section 2324(h), Allowable Costs Under Defense Contracts, United States Code, Title 41, Section 256(h), Allowability of Costs, and FAR 42.703-2, Certificate of Indirect Costs, contractors are required under penalty of perjury to certify that all costs in the proposal are allowable in accordance with the requirements of contracts to which they apply and with the FAR cost principles. FAR 31.201-6 repeats the requirement that contractors affirmatively "exclude" costs that are either expressly unallowable or mutually agreed to be unallowable for non-Cost Accounting Standard-covered contractors. 10 U.S.C. 2324(a) through (d) and 41 U.S.C. 256(a) through (d) also prescribe penalties for submission of unallowable costs in final indirect cost rate proposals. The penalties include the amount of the disallowed costs plus interest. However, a penalty of two times the amount should be assessed if the costs were determined to be unallowable before submission. Some examples of expressly unallowable costs are:

- entertainment costs;
- costs incurred to influence legislation;
- costs incurred in defense of civil or fraud proceeding;
- fines and penalties;
- memberships in social, dining, or country club;
- alcoholic beverages;
- contributions or donations; and
- golden parachute-type costs.

Audit Policy Memorandum Number 5, Performance and Reporting of Nonmajor Incurred Cost Audits. On April 23, 1992, we issued Audit Policy Memorandum Number 5, Performance and Reporting of Nonmajor Incurred Cost Audits, after unsuccessful attempts at reaching agreement with DCAA on performing transaction testing to source documents during incurred cost audits. Three evaluations had shown critical audit steps were not being performed to determine the allowability, allocability, or reasonableness of contractor-claimed costs. The DCAA requested and we granted a delay in implementing Audit Policy Memorandum Number 5 to provide sufficient time for it to prepare training, guidance, and audit programs. Our policy requires DCAA to perform minimum essential audit steps to accept contractor-claimed costs. In January 1994, the DCAA proposed to the Deputy Inspector General, DoD, an incurred cost sampling initiative for small low-risk contractors. Because the sampling initiative did not comply with our audit policy requiring transaction testing, we planned to consider a deviation upon evaluation of the proposed initiative and resolution of our report recommendations.

Incurred Cost Sampling Initiative. The objective of the initiative was to redirect audit effort from small low-risk incurred cost audits to higher risk audit areas. The plan used prior audit experience to stratify small contractors into two groups: high-risk contractors who would be audited annually and low-risk contractors that would be audited a minimum of every 5 years. High-risk contractors were defined as those who had cost questioned in the prior year incurred cost audit, no prior audit experience, or had known audit problems. Low-risk contractors were defined as those with no prior year cost questioned, a clean audit history, and no known audit leads. A statistical sample of 20 percent of the low-risk contractor incurred cost proposals universe would be selected every year for audit. The remaining 80 percent in the universe would be closed out by a desk review during the year. A desk review does not include any transaction testing and is essentially performed at the DCAA audit office without visiting the contractor's site.

On September 30, 1993, the DCAA backlog was $9.8 billion for 8,670 contractor submissions of $5 million or less, with 4,700 ($5.8 billion) submitted and ready to be audited. The DCAA stated that high-risk contractors would

comprise 40 percent of the backlog based on the historical average of audits with cost questioned, with the remaining 60 percent classified as low-risk. Accordingly, the DCAA estimated 75 staff years would be redirected to high-risk audits based on the proposal to sample 20 percent of the low-risk proposals on hand and perform a desk review of those proposals not sampled.

Pilot Test. Because of staffing constraints on DCAA and the need to reduce the backlog, we agreed to test the proposed sampling initiative for 6 months from July 1 through December 31, 1994. The test simulated the actual implementation of the sampling initiative, except that no low-risk incurred cost proposal would be closed by desk review during the test period until a joint DCAA/Inspector General, DoD, assessment was completed.

Soon after implementing the test and reassessing the historical data, DCAA determined the high-risk pool comprised 86 percent of the universe, not 40 percent as originally estimated. The original estimate was based on historical data that showed 40 percent of these audits resulted in questioned cost. However, the reassessment of the universe disclosed more contractors than just those with questioned cost were classified as high-risk. Due to the reduction in the low-risk pool (60 percent down to 14 percent), the estimated resource savings available to be redirected to high-risk work was now projected to be 19 staff years, not the 75 staff years originally proposed.

A joint DCAA/Inspector General, DoD, review of 10 field audit offices (FAOs) was conducted during March 1995. The scope of this review included the establishment of the universe of under $5 million ADV contractors, the identification of high/low-risk contractor proposals in the universe, the performance of low-risk incurred cost audits, and the implementation and compliance with nonmajor incurred cost audit guidance as issued on November 15, 1993.

We participated in reviews of the Rosslyn and Silver Spring Branch Offices. The other eight FAOs were reviewed by Headquarters, DCAA, personnel with assistance from regional personnel. We reviewed the exit notes and supporting documentation for the visits to the eight offices to verify that the evaluation criteria was interpreted and applied consistently. Based on our review of the files documenting the results of the visits to the eight FAOs, we found results consistent with or similar to the two FAOs we reviewed.

The 6-month test revealed that of the 127 low-risk audits performed, 33 (26 percent) had questioned cost. The questioned costs for about half of these audits were $5,000 or less. We determined that, in many cases, the questioned costs related to one questioned item that could be determined from a desk review of the proposal. We also found that 16 (20 percent) of 77 submissions were incorrectly classified as low risk. The 16 submissions should have been classified as high risk because the prior audits had costs questioned, inadequate transaction testing, or audit leads not addressed.

Audit Interval. On August 4, 1995, the Assistant Director for Policy and Plans, DCAA, briefed us on draft audit guidance that provided for reviewing a sample of low-risk, $5 million or less ADV cost proposals. We took issue with

several provisions in the audit guidance, but mainly with the use of a newly proposed 4-year cycle versus the 3-year cycle we advocated. The initial test used a 5-year cycle. Throughout the joint review, we stated that published guidelines such as the Office of Management and Budget circulars and the General Accounting Office only allowed a 3-year risk cycle. The DCAA agreed to delay the issuance of the audit guidance pending our review and agreement on the procedures.

On August 25, 1995, DCAA issued agreed-to procedures (95-PFD-122) using a 3-year risk cycle for reviewing low-risk, $5 million or less ADV cost proposals reviewed on a sample basis. Additional guidance issued in September 1995 (95-PIC-141) and April 1996 (96-PIC-041) subsequently clarified the procedures.

In September 1996, we completed the final phase of our evaluation on the audit guidance for selecting low-risk proposals and the desk-review procedures used to close incurred cost proposals not selected for audit. We concluded that the selection of proposals and the desk-review procedures were properly implemented.

Adjustment of Unaudited Years Costs. To protect the Government's interest in those years closed by desk-review procedures, the contractor's annual indirect rate agreement letter should include a statement to the contractor that the costs may be adjusted if expressly unallowable costs were subsequently found when performing an audit. Expressly unallowable costs are those costs that the contractor must certify are not in its proposals, are in noncompliance with the Cost Accounting Standards, or incurred as a result of fraudulent practices. The DCAA should modify its DCAA Contract Audit Manual, 6-7SI Supplement, Pro Forma Final Indirect Cost Rate Agreement, to alert the contractor that recovery of expressly unallowable costs will be pursued if included in years closed by desk-review procedures. Expressly unallowable costs are identified by law and regulation and may not be claimed. Access to years closed by desk review and not audited can be gained through these statutes. Also, FAR 52.215-2, Audit and Records-Negotiation, requires contractors to make records available for examination or audit until 3 years after final payment.

The sampling plan is an initiative that benefits contractors by reducing audit coverage for low-risk contractors. Because the contractor is required to screen out expressly unallowable costs, the finding of expressly unallowable costs in a subsequent year's audit should be the exception rather than the norm. However, if expressly unallowable costs are identified, penalties and interest would be applicable in accordance with law and FAR regulation.

Subsequent DCAA Guidance. On October 23, 1996, DCAA issued new implementing guidance (96-PIC-148) on the sampling plan procedures. The new guidance stipulates that a contractor with $500,000 or less in auditable costs, with no audit leads indicating a high probability of significant questioned costs, would be classified as low risk. Further, the new guidance raises the cost questioned criteria for low risk from $0 to $10,000 and provides for a contractor to be rated as low risk if DCAA has incurred cost audit experience with the contractor. The new criteria shifts 106 of 304 contractors from a high

to low risk classification. The guidance was never proposed as part of the sampling initiative and was not evaluated during the field test of the DCAA proposed initiative. In our opinion, the contractors should only be placed in the sampling plan as low risk if they meet the low-risk criteria in the August 25, 1995, guidance evaluated during our review.

The October 23, 1996, guidance is not accepted as a deviation from Audit Policy Memorandum Number 5.

Recommendations, Management Comments, and Evaluation Response

Revised Recommendation 1. As a result of DCAA comments, we revised draft Recommendation 1 to provide for recovery of expressly unallowable costs without adjusting the final indirect expense rates. However, the final rate agreement letter must contain a statement alerting contractors of the Government rights. See Enclosure 3 for the entire DCAA comments.

We recommend the Director, Defense Contract Audit Agency:

1. Include a statement in final rate agreement letters for years closed by desk reviews that the Government can recover expressly unallowable cost through Cost Accounting Standards and debt collection procedures, without adjusting the final rates, if the first audit of a subsequent fiscal year determines that expressly unallowable costs are claimed and questioned in that audit.

Management Comments. DCAA concurred in principle with the objectives but not with the specific recommendation. DCAA stated that the final rates, once properly established, are binding and not subject to adjustment, absent special circumstances such as fraud. However, DCAA agreed that the statutory prohibition on payment of expressly unallowable costs allows the Government the right to recover expressly unallowable costs without adjusting the rates. DCAA agreed to work with General Counsel to develop audit guidance on CAS 405 recovery and how and when to recommend contracting officer pursuit of recovery using debt collection procedures.

Evaluation Response. We accept the DCAA concur in principle as agreeing to pursue recovery of the expressly unallowable costs, but not through adjustment of the rates. We revised the recommendation based on this comment. However, DCAA failed to respond to the recommendation that the letter agreement alert the contractor of these conditions. As a new technique benefiting the contractor and the Government, it is important to explain what will occur if expressly unallowable costs are subsequently found. Our recommendation to include a statement in the final rate letter of the Government's rights and protections under the new sampling plan initiative must be implemented. We request the date the new guidance will be issued and that a copy of the proposed guidance be provided for our coordination prior to issuance. The DCAA also needs to respond to the entire final report recommendation.

2. Rescind the October 23, 1996, guidance (96-PIC-148).

Management Comments. DCAA nonconcurred with rescinding its October 23, 1996, guidance. DCAA stated that the October guidance does not materially deviate from the August 1995 guidance. The latest guidance simply provided materiality guidelines that permit greater flexibility in exercising auditor judgment. The new guidelines foster better audit judgment and result in a wiser use of audit resources. DCAA states the new guidance recognizes that contractor claims of less than $500,000 represent a lower risk because the absolute dollars are relatively low and that the likelihood of finding an exception equal to or greater than the cost of performing the audit is unlikely. Similarly, the guidance provides a $10,000 guide for assessing when a prior year's exception was significant enough to classify the contractor as high risk. This guide is based on an assessment that compared cost of performing the audit with likely benefits. DCAA also stated that the draft report incorrectly stated that the cost questioned criteria for low risk changed from $5,000 to $10,000. DCAA stated that the criteria was never $5,000.

Evaluation Response. The revised guidance significantly deviates from the sampling plan the Director, DCAA, initially proposed and which was jointly agreed to evaluate. Before new or additional guidance is issued, the original concept should be evaluated to determine its appropriateness.

$500,000 Low-Risk Criteria. The new $500,000 low-risk criteria is without justification, and will result in contractors with significant internal control weaknesses and questioned costs being classified as low risk. DCAA stated that the $500,000 criteria recognizes the low probability of finding an exception equal to or greater than the cost of performing the audit. However, part of the rationale for the audit function is the deterrent effect that is created by the expectation of an audit. Eliminating audit coverage as a matter of policy correspondingly eliminates the deterrent to submitting questionable or even unallowable costs. As a result, such a policy could act to significantly increase the risk present at contractors with under $500,000 in auditable costs. Also, DCAA statistics show that the costs questioned in audits below $500,000 was more than twice the audit cost in FY 1995 and almost twice the audit cost in 1996. In FYs 1995 and 1996, DCAA questioned $5.6 million and $4.5 million, respectively compared to audit costs of $2.4 million and $2.6 million. DCAA revised criteria will result in almost $5 million (cost questioned exceeding audit cost) being immaterial and thus not questioned. These contractors should be classified as high risk until they meet the low-risk criteria included in the field test of the DCAA initiative. Moreover, our prior evaluations found DCAA audits of these size contractors were consistently inadequate resulting in the costs questioned being understated. Using the DCAA $500,000 criteria, these contractors may never be audited. Since the audits more than pay for themselves, and have an indeterminate but positive effect on controlling contract costs at other contractors, we cannot support deletion of the audit requirement. In our view, it is not acceptable to eliminate altogether the deterrent effect of the audit function on low-dollar value contractors.

$10,000 Materiality Criteria. DCAA is correct that there was never any formal agreement on a $5,000 materiality criteria mentioned in our draft

report. The bottom line for questioned costs, during the field test of the DCAA initiative, was $0. However, DCAA now proposes to use a $10,000 criteria that was neither considered nor evaluated in testing the initiative. We continue to believe, as explained to DCAA during discussions of the draft report recommendations, that materiality of questioned costs must be measured against the universe under audit. While $10,000 may not be material in the audit of a $10 million contract, it is material to a $100,000 contract. Contrary to the DCAA response that its new guidance permits greater flexibility in exercising auditor judgment, the $10,000 criteria could lead to auditor acceptance of $10,000 of unallowable costs without applying auditor judgment to relate the questioned costs to the universe under audit. By establishing an acceptable tolerance for submission of unallowable costs, such a practice is actually encouraged rather than discouraged.

We also note that DCAA-proposed $10,000 materiality criteria is based on that in Office of Management and Budget Circular A-133 applicable to nonprofit organizations. The Office of Management and Budget criteria was based on the low-risk nature of nonprofit organizations. However, DCAA proposes to apply it in a for-profit industry where the motivation for increasing cost recovery or profits is much higher, thus increasing the risk to the Government.

Absent any detailed support by the DCAA, we believe the new DCAA procedures are not fundamentally sound and do not result in focusing audit resources on the highest risk contractors. Small contractors may not have the means to maintain strong internal controls such as segregation of duties. Therefore, the new procedures will be in noncompliance with Audit Policy Memorandum Number 5 (as revised) and should be rescinded. The DCAA August 25, 1995, guidance as tested and agreed to in our field evaluation should be implemented retroactively for FY 1997. After a 3-year or one full test cycle, the sampling plan may be re-evaluated for needed changes based on a full and comprehensive analysis of all pertinent issues.

Management Comments

DoD Directive 7650.3 requires that all recommendations and issues be resolved promptly. We request additional comment as specified after the recommendations within 60 days. Questions on the evaluation should be directed to Mr. Wayne C. Berry, Project Manager, at (703) 604-8737 (DSN 664-8737). See Enclosure 4 for the report distribution.

Russell A. Rau
Assistant Inspector General
Policy and Oversight

Enclosures

Summary of Prior Evaluation Reports

Three Office of the Inspector General, DoD, reports covered issues related to this evaluation.

Audit Policy and Oversight Report No. 91-020, "Report on Review of the DCAA Performance of Incurred Cost Audits on Mobile Contractors," was issued September 13, 1991. Audits did not contain vital steps to review costs for allocability, allowability, and reasonableness; include contract briefs; fully disclose the adequacy of the contractor's internal controls and the assessment of control risk in the final report; and use multi-year audits to maximize audit resources. Mediation attempts were unsuccessful in trying to achieve a mutually acceptable agreement between our office and DCAA concerning disputed recommendations. At issue was the DCAA failure to agree to perform transaction testing to source documents during incurred cost audits. Accordingly, we developed and issued on April 23, 1992, Audit Policy Memorandum Number 5, "Performance and Reporting of Nonmajor Incurred Cost Audits." Audit Policy Memorandum Number 5 required the performance of minimum essential audit steps and transaction testing during first-time audits, during multi-year audits, and a minimum of every other year when auditing a single fiscal year.

Audit Policy and Oversight Report No. APO 87-008, "Report on Follow-up Oversight Review of Mobile Incurred Cost Audits," was issued May 28, 1987. Although DCAA had improved some areas previously identified as deficiencies in Report No. APO 85-008, some audit offices still were not providing sufficient audit coverage on incurred cost audits. Deficiencies were identified in the area of accomplishing the mandatory annual audit requirements. In addition, improvements were needed in the preparation and use of internal control questionnaires and vulnerability assessments. Recognizing the need for new guidance on the mandatory annual audit requirements, Headquarters, DCAA, concurred with our recommendations and issued new guidance before we issued our final report. However, after agreeing to perform the mandatory annual audit requirements at all contractor locations, Headquarters, DCAA, revised its guidance in 1988 and advised the performance of the mandatory annual audit requirements at nonmajor contractors was discretionary depending on their applicability and materiality.

Audit Policy and Oversight Report No. APO 85-008, "Report on Oversight Review of Mobile Incurred Cost Audits," was issued January 4, 1985. DCAA needed improved guidance to assure more consistent and adequate audit coverage for contractors audited on a mobile basis. Each region had different interpretations and approaches in meeting generally accepted Government auditing standards for incurred cost audits. Many DCAA field auditors were not fully complying with auditing standards relating to planning, supervising, and reporting. Compliance with these standards was necessary to assure effective use of resources, proper audit coverage, quality of audit work, and full disclosure of audit results.

Organizations Visited or Contacted

Defense Contract Audit Agency

Austin Branch, Austin, TX
Boston Branch, Boston, MA
Denver Branch, Lakewood, CO
Great Lakes Branch, Detroit, MI
Huntsville Branch, Huntsville, AL
Minneapolis Branch, Minneapolis, MN
Nashville Branch, Nashville, TN
North County Branch, San Diego, CA
Oxnard Branch, Oxnard, CA
Rosslyn Branch, Springfield, VA
San Fernando Valley Branch, Van Nuys, CA
Silver Spring Branch, Silver Spring, MD

Defense Contract Audit Agency Comments

DEFENSE CONTRACT AUDIT AGENCY
8725 JOHN J. ROAD, SUITE 2135
FORT , VA 22060-6219

IN REPLY REFER TO

PIC 225.4 [No. 60C-9035] 7 May 1997

MEMORANDUM FOR DEPUTY ASSISTANT INSPECTOR GENERAL, AUDIT POLICY AND OVERSIGHT, DEPARTMENT OF DEFENSE

SUBJECT: DCAA Comments to DoDIG Draft Report on Defense Contract Audit Agency Sampling Initiative of Incurred Cost Proposals on Low-Risk Contractors, (Project No. 60C-9035)

Thank you for the opportunity to respond to the subject report. We also appreciated the opportunity to discuss with you and your staff on 9 April the issues raised in your report. I am hopeful this constructive dialog will help ensure a satisfactory outcome.

The report addresses DCAA's initiative (effective August 1995) to more effectively manage and focus its incurred cost audit resources on significant areas of financial risk to the government. The initiative allows auditors to use sampling techniques to perform desk reviews (versus audits) on selected **low-risk** contractors' incurred cost proposals.

Your report concludes on page 1 that DCAA has effectively implemented the August 1995 initiative. Despite the positive overall assessment you present two recommendations that DCAA does not fully concur with. Our concerns are summarized below.

Recommendation No. 1 (Page 7). The draft report recommends that the Director, DCAA:

> Include a statement in final rate agreement letters for years closed by desk reviews to alert contractors that if the first audit of a subsequent fiscal year determines that expressly unallowable costs are claimed and questioned in that audit, then the desk review indirect expense rates can be adjusted if they, too, contain expressly unallowable costs.

DCAA Response to Recommendation No. 1. Concur in principle with the objective, but not with the specific recommended action. Instead, we believe that the two alternative remedies discussed below may be more appropriate actions for recovering expressly unallowable costs included in closed years.

In response to our request for legal comments on the above recommendation, DCAA's General Counsel has opined that once final indirect cost rates are properly established, the rates are binding on the government and not subject to unilateral repudiation, absent special circumstances; e.g. fraud. A copy of this opinion has been forwarded to you.

PIC 225.4 [No. 60C-9035]
SUBJECT: DCAA Comments to DoDIG Draft Report on Defense Contract Audit Agency Sampling Initiative of Incurred Cost Proposals on Low-Risk Contractors, (Project No. 60C-9035)

The legal opinion also pointed out that, because of the statutory prohibition on the payment of expressly unallowable costs, the government may have the right to recover expressly unallowable costs without adjusting the final indirect rates. Two potential remedies are:

- Cost Accounting Standards (CAS) clause for CAS-covered contracts; and
- Debt collection procedures set forth in FAR 32.6.

CAS 405 requires contractors with CAS-covered contracts to separately account for their expressly unallowable costs and to exclude them from their CAS-covered contracts. Contractors including these costs in their final indirect cost rates would be in noncompliance with CAS 405 and the provisions of the CAS clause. In this situation, the government is entitled to a contract adjustment to recover the expressly unallowable costs.

Under the debt collection procedures, if a contract debt is indicated, the contracting officer will be responsible for establishing and negotiating the debt. If it is not possible to negotiate the debt, the contracting officer is empowered to issue a unilateral decision under the Disputes clause, FAR 52.233-1.

DCAA has and will continue to pursue recovery under CAS 405 noncompliances. In addition, we will work with our General Counsel to develop audit guidance on how and when auditors should recommend contracting officer pursuit of recovery using debt collection procedures.

Recommendation No. 2 (Page 8). The draft report recommends that the Director, DCAA,

Rescind the October 23, 1996, (96-PIC-148) guidance.

The background and explanation for the recommendation (from page 7 of the draft report) is restated below:

> **Subsequent DCAA Guidance Changes.** On October 23, 1996, DCAA issued new implementing guidance (96-PIC-148) on the sampling plan procedures. The new guidance stipulates that a contractor with $500,000 or less auditable costs, with no audit leads indicating a high probability of significant questioned costs, would be classified as low risk. Further, the new guidance raises the cost question criteria for low risk from $5,000 to $10,000 and provides for a contractor to be rated as low risk if DCAA has incurred cost audit experience with the contractor. The guidance was never proposed as part of the sampling initiative and was not considered by us during our evaluation. These contractors should only be placed in the sampling plan as low risk if they meet the low-risk

PIC 225.4 [No. 60C-9035]
SUBJECT: DCAA Comments to DoDIG Draft Report on Defense Contract Audit Agency Sampling Initiative of Incurred Cost Proposals on Low-Risk Contractors, (Project No. 60C-9035)

criteria in the August 25, 1995, guidance evaluated during our review. The October 23, 1996, guidance is not accepted as a deviation from Audit Policy Memorandum Number 5.

DCAA Response to Recommendation No. 2. Nonconcur.

As discussed at our 9 April meeting, we believe the October 1996 audit guidance does not materially deviate from DCAA's August 1995 audit guidance. The latest guidance simply provides materiality guidelines that permit greater flexibility in exercising auditor judgment. We believe the new guidelines foster better audit judgment and result in wiser use of audit resources.

The October 1996 guidance recognizes that contractor claims of less than $500,000 represent a lower risk because the absolute dollars are relatively low and that the likelihood of finding an exception equal to or greater than the cost of performing the audit is unlikely. Similarly the October 1996 guidance also provided a working guideline -- $10,000 -- for assessing when a prior year's exception was significant enough to classify the contractor as "high risk." Here again, the $10,000 is based on an assessment that compared the cost of performing the audit against the likely benefits.

Enclosed is more detailed rationale regarding the basis for our materiality guidelines. The rationale is fundamentally sound in terms of helping ensure audit resources are focused on the highest risk contractors without exposing the Department to significant lost savings. We believe in today's environment, this kind of sound risk management is essential to maximize the effectiveness of Department audit resources.

You mentioned in arriving at your recommendation for DCAA to rescind its audit guidance, you had not fully considered our rationale supporting the October 1996 materiality guidelines. You further stated that the basis for Recommendation No. 2 was -- not because you had judged our materiality guidelines to be inappropriate -- but, because you were not given an opportunity to evaluate the guidance prior to its issuance. You stated that advance approval was required because the guidance was part of the overall sampling initiative that you were reviewing to determine its acceptability as a deviation from Audit Policy Memorandum Number 5 (APM-5).

While we now understand the logic behind your decision to recommend rescission of our guidance, we do not believe it should undermine otherwise sound audit policy. We believe after you have a chance to objectively review the basis of our materiality guidelines, you will agree DCAA's adoption and implementation of the criteria is both effective and prudent.

As an aside, the draft report statement that our October 1996 guidance raised "the cost question criteria for low risk from $5,000 to $10,000" is inaccurate. I believe you now agree there was never any "$5,000" materiality criteria prior to our issuance of the October 1996 guidance.

PIC 225.4 [No. 60C-9035]
SUBJECT: DCAA Comments to DoDIG Draft Report on Defense Contract Audit Agency Sampling Initiative of Incurred Cost Proposals on Low-Risk Contractors, (Project No. 60C-9035)

Please direct any questions you may have regarding this memorandum to Mr. Henry Simpkins, Chief, Incurred Cost Division, at (703) 767-2250. We look forward to working with you in the near term to resolve our differences.

Lawrence P. Uhlfelder
Assistant Director
Policy and Plans

Enclosure:
a/s

$10,000 WORKING GUIDELINE FOR ASSESSING MATERIALITY

This *working guideline* was developed taking into consideration the following:

1. **Audit judgment** -- The audit guidance states that this is a *working guideline* only, and that the auditor must continue to *exercise good audit judgment* in making final determinations of audit risk. [See MRD 96-PIC-148(R), page 1.] The DCAA auditor will consider leads with a cost impact on flexibly priced contracts of less than $10,000. If the auditor is aware of a cost exception and the item is worth pursuing, (i.e., good probability of recovery, sensitive issue, etc.), the auditor will pursue the questioned item.

2. **Materiality guideline** -- The underlying premise for the $10,000 *working guideline* is similar to the *materiality guideline* developed between the Deputy Inspector General, DoD, and the Director, DCAA, for assessing significance in defective pricing.

3. **Estimated cost of audit** -- The *guideline* represents our estimate of the costs of a DCAA audit to the Government. This estimate represents the costs incurred by the (1) DCAA, (2) contractor, and (3) contract administration office to perform the audit and to support and resolve audit exceptions.

4. **Penalty waiver** -- This is the ceiling amount specified in FAR 42.709-5 that provides the contracting officer an opportunity to *waive application of penalty* when the final indirect cost submission includes unallowable costs subject to penalty.

5. **Materiality factor for reporting questioned costs** -- This is the *minimum* amount for reporting questioned costs identified by the auditor in an audit conducted in accordance with OMB Circular A-133 "Audit of Institutions of Higher Education and Other Non-Profit Institutions," dated 22 April 1996. See Circular A-133, §._510(3).

$500,000 THRESHOLD FOR CLASSIFYING PROPOSAL AS LOW RISK

This threshold was developed taking into consideration the following:

1. **Penalty threshold** -- Federal Acquisition Regulation 42.709, which requires that penalties be assessed when expressly unallowable costs are claimed, applies to all cost type and fixed-price incentive contracts in excess of $500,000.

2. **Cost or pricing data threshold** -- DCAA's threshold is less than that required for obtaining cost or pricing data under FAR 15.804-2, "Requiring cost or pricing data."

3. **Waiver for audit** -- OMB Circular A-133 and the Single Audit Act Amendments of 1996, [PL 104-156] provide for a $300,000 threshold exempting certain contractors from an audit. DCAA policy does not advocate a waiver of the audit, but rather it establishes a threshold for placing a proposal into the low risk pool, where it is subject to audit selection. See Circular A-133, Subpart B §_.200(a). See PL 104-156, Sec. 7502(a)

Enclosure

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