



# UNDERSTANDING THE DIFFERENT TYPES OF **DCAA** AUDITS

When you receive a contract from the United States government, you are entering into a business relationship with the largest purchaser of goods and services in the world. It is an organization that is highly sophisticated, with written and unwritten rules and expectations —and stiff consequences when not satisfied.

**In general, the government will purchase goods and services by one of three methods:**

- 1 On a fixed price basis.**  
For example, contractors sell commercially available items to the government through the General Services Administration (GSA) schedule.
- 2 On a time and materials basis.**  
For example, services can be contracted to a specific government agency at a fixed hourly rate (and may be subject to the Service Contract Act).
- 3 On a cost-reimbursable basis.**  
For example, Research and Development (R&D) and projects that have potential, but no satisfactory existing commercially viable solutions.

This white paper will provide an overview of the different types of government audits that cost-reimbursable type contracts are subject to so you can make informed decisions about the proper oversight of your accounting system.






## COST REIMBURSABLE CONTRACTS

Cost-reimbursable contracts come from a variety of agencies, in a number of sizes, and with standard and unique reporting requirements. If you have a federal contract containing Federal Acquisition Regulation (FAR) clause 52.216-7 Allowable Costs the award is a cost-reimbursable type funding vehicle. These awards require the recipient to carefully account for actual project costs (including the proportional indirect costs) according to the accounting and administrative requirements contained in the FAR, Cost Accounting Standards (CAS), and DoD Supplemental Regulations (DFAR).

## THE ROLE OF THE DEFENSE CONTRACT AUDIT AGENCY (DCAA)

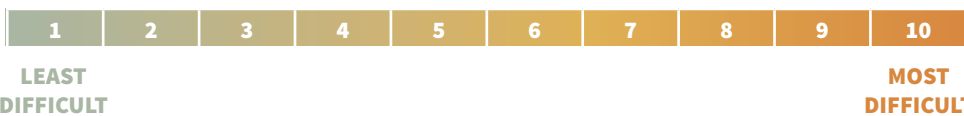
It's important to understand that in order to minimize potential government collusion, the federal procurement process requires at least three independent individuals to oversee and sign off on your ongoing funding relationship with the government over the life of your award:

-  Technical customer
-  Procuring contracting officer (PCO)
-  Auditors (DCAA)

The DoD maintains thousands of DCAA auditors in more than 300 branch locations in order to ensure that you can demonstrate your ongoing compliance with the FAR, DFAR, and CAS, as well as any contract-specific requirements.

DCAA has the responsibility to protect the public interest by scrutinizing the use of taxpayer dollars used to fund DoD awards. In order to monitor the proper spending on these awards over the life of the project, DCAA has developed different types of audits to cover the entire procurement cycle beginning before the award is funded and concluding with a final audit, in order to accurately document the cumulative costs of a project and close out the contract.

Below, we discuss several of the more common types of DCAA audits, their purpose, and provide some perspectives. We've added a "how hard is it to pass" score on a scale of (1-10), with (10) being most difficult, based on our experience from the thousands of DCAA audits we've helped our clients pass over the past three decades —representing more than \$4 billion dollars in government funding.



The following types of Department of Defense (DoD) funding vehicles usually have FAR 52.216-7 embedded in the terms and conditions of their award:

- SBIR/STTR Phase II
- IDIQ
- BAA

If you've received one of these awards, you must establish an acceptable accounting system, and maintain it in an "always audit ready" manner.



## Pre-Award Survey

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Before your company receives its first cost-reimbursable award, you will meet your first DCAA auditor. The Procuring Contracting Officer (PCO) will direct DCAA to perform a preliminary review of your accounting system in order to make sure you are ready to do business with the federal government.

DCAA's goal in a pre-award survey is to review the prospective contractor's accounting system and related internal controls to provide reasonable assurance that:

- ✓ Applicable laws and regulations are complied with
- ✓ Accounting system and cost data are reliable
- ✓ Risk of misallocations and mischarges are minimized
- ✓ Contract allocations and charges are billed the same way they are accounted for

More specifically, DCAA will focus on your ability to:

- ✓ Allocate costs among contracts in a logical manner
- ✓ Exclude unallowable costs
- ✓ Record employee labor hours and dollars by contract
- ✓ Segregate direct and indirect costs
- ✓ Provide timely, accurate cost accounting data to support billings
- ✓ Provide accurate data to support incurred costs claimed by contract

### What's at stake?

We frequently hear stories of companies who fail a pre-award survey and lose out on a \$1.5 million Phase II SBIR award.

In fact, we recently started working with a client who hired us after failing their pre-award survey and initial accounting system review. They had \$3 million in contracts delayed for nine months until we were able to install a proper accounting system and then have that system re-audited under heavy scrutiny. This delay forced the client to lay off key personnel and seriously set back the timeline for development of their technology.

In the big picture of DCAA audits, the bar is fairly low.

The government wants to do business with you and despite anything you might read to the contrary, DCAA's own internal training (some of which can be found on the web) encourages them to work with you and the PCO to resolve pre-award findings.



## (Full blown) Accounting System Review

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This audit is similar to the pre-award survey, except that the full blown accounting system review is typically a multi-day, on site audit of virtually every aspect of the accounting system. The intensity of the systems reviewed is determined by the total value and types of awards you have with the Federal government.

The main purpose of the accounting system review is to ensure that you have the internal controls in place to properly monitor project costs and invoice the government, and be able to demonstrate that the controls are working. Some commonly tested controls include:

- ✓ Displaying segregation of duties, as prudent, including:
  - The person reconciling the operating cash account is not also in charge of invoicing and disbursing funds.
  - Vouching and coding of expenses, including approvals, are designed and working properly.
- ✓ Proving that the labor distributed in the general ledger (an accrual basis document) reconciles to the outside payroll tax returns (a cash basis document).
- ✓ Demonstrating that the job cost reports reconcile to the general ledger for a certain time frame and can be reconciled to current and cumulative amounts billed to the government.
- ✓ Allowing the auditor to verify that you accumulate costs as either direct, indirect or unallowable expenses and can provide a monthly calculation of your actual indirect cost rates.

## Provisional Billing Rate Audit

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\*2 out of 10 for a lower indirect rate, but more difficult for a higher rate

Now that you passed your accounting system review, received your contract and submitted your first invoice, you may be wondering why the government hasn't paid you. The answer may be because your provisional billing rates (a.k.a. indirect cost rates) have not been approved.

The procedures for establishing provisional billing rates are governed by FAR 42.704.

The purpose of a provisional billing rate is to establish a method to reimburse the contractor for interim (monthly) payments. Monthly vouchers and progress payments can be returned as unpaid if submitted without properly establishing provisional billing rates.



It's important to understand that provisional billing rates must be monitored against actual indirect cost rates on a monthly basis. Provisional billing rates may be adjusted by either party at any time to prevent potential substantial over billing or under billing.

The government asks contractors to voluntarily submit a billing rate proposal to assist DCAA and the Administrative Contracting Officer (ACO) in establishing indirect cost rates on an annual basis in the month preceding the beginning of your fiscal year – December for most companies. DCAA prefers your projections to be prepared electronically (in Excel) and sent to them in an email. This allows them to run the following tests from their office (which is known as a desk audit):

- ✓ Perform a fluctuation analysis where they compare proposed pool (numerator) and base (denominator) expenses to prior year, and year-to-date amounts
- ✓ Review trends of questioned costs in relevant incurred cost audits

Some of the more common deficiencies include:

- ✗ Failure to remove unallowable costs from the numerator
- ✗ Failure to adjust provisional billing rates based on actual experience

**Be prepared to provide an explanation of any significant differences.**

We are stupefied by the frequency of new clients we work with who bid incredibly low indirect cost rates on their initial government contract proposals. Then as time passes, they find it difficult to grow their business because the funds necessary to help build the infrastructure for the business were not requested.

In one case, we had a client who realized as time passed that his competitors were building more sophisticated solutions than he was because their higher indirect cost rates allowed them that freedom. However, as he began to systematically attempt to increase his indirect rates over time he ran into more and more resistance from DCAA, who ultimately prepared regression analyses as a way to substantiate their position against his higher indirect cost rate request. Later, the client acknowledged the short sightedness of his initial decision to bid such a low indirect cost rate and realized that DCAA made it harder for his business to compete because of his indirect rate history.

**IMPORTANT NOTE:**  
The settlement, or true-up, of final indirect rates is established during the audit of the annual incurred cost submission, which is discussed below.







### Progress Payment Audit



\*Assuming you're maintaining job costs and billing properly

In order to ensure visibility into contract costs as work progresses, DCAA performs progress payment audits on individual invoices.

After you submit an invoice, you may receive a call from a DCAA auditor to let you know that the invoice submitted has been selected for audit, and you are now tasked with providing substantiation for each individual line item on the invoice – working backwards all the way to the supporting document for the initial creation of cost:

- ✓ From government invoice back to job cost report, then
- ✓ From job cost report back to source documents:
  -  Labor costs distributed – traced back to payroll reports, and approved, properly coded timesheets
  -  Consultant and subcontractor costs - traced back to approved properly coded invoices, and agreements
  -  Travel costs – traced back to expense reports, coding, approvals and analyses of per diem limitations
  -  Indirect costs applied – traced back to the indirect cost rate agreement

### Surprise Time Sheet Audit



\*Could be 10 out of 10 if you have a disgruntled employee!

DCAA understands that payroll is usually the largest cost for most small businesses, and that labor charges are relatively easy to manipulate. As a result, timekeeping policies merit special scrutiny by DCAA — and timekeeping irregularities have led to more criminal investigations than any other accounting system anomaly.

Furthermore, the federal False Claims Act allows private citizens who allege government programs are being defrauded to file actions on behalf of the government and receive a portion of the recovered damages — usually 15% to 30%.



Expect it when you least expect it. The goal of this surprise time sheet audit (also known as a floor check), is to ensure that you and your employees are following the government’s strict timekeeping rules, which we outline in our whitepaper titled “[Understanding the Basic Accounting Requirements for Federal Government Awards](#)”.

The audit is quite simple, but can be quite intimidating. DCAA will visit your facility unannounced, flash their badge, and randomly select employees for questioning. These employees must be ready to properly answer questions on timekeeping procedures and be able to demonstrate that their timesheets reflect those procedures.

One company was too late in requesting our help in an attempt to save itself after receiving a surprise timesheet visit from DCAA. The business owner (and CEO) had asked his wife (the CFO) for a divorce and the next day an auditor appeared to perform a surprise floor check. After DCAA performed interviews with company personnel, it was determined that the business owner was instructing his employees to charge time to certain cost reimbursement jobs in violation of proper timekeeping policies. Upon learning this fact, DCAA suspended all of the company’s contracts, effectively forcing the business owner to file for bankruptcy. The CEO ultimately took a job working for one of his employees.

For our clients with labor charging concerns, we offer mock time sheet audits. Of greater importance, we work with management to develop more effective policies, and how to properly coach employees on their work plans, work ethic issues, time charging and time sheet correction disciplines.

### Financial Capacity Audit



In this audit, DCAA performs extensive balance sheet analysis of your organization to determine its underlying financial solvency. The government doesn’t want to do business with companies who will not be able to perform on a contract due to inadequate financial resources.

During this analysis, DCAA will calculate many common financial ratios to determine the level of your financial viability, with your current ratio, and debt-to-equity ratio being of critical importance. If you are struggling, it’s important to make as many disclosures about your financial condition as possible during this process, such as an infusion of capital, significant cost cuts planned, and the like.



Failure of a financial capacity review will often lead to your company being overlooked for upcoming awards as you are seen as a financial risk. The appeal process for failing this type of review can be extremely time consuming and expensive.



Annual Incurred Cost Audit



\*Depending on DCAA's risk analysis

Every cost-reimbursable type contract contains FAR 52.216-7 The Allowable Cost Clause. This clause requires you to submit an annual “true up” report, also known as an Incurred Cost Submission within 180 days after your fiscal year end.

A sample of the [annual incurred cost submission](#), a fairly hefty document, can be found by clicking on the ‘download now’ button to the right. In a nutshell, this document represents your final cost accounting for all the activity from your business for the prior year, in accordance with the FAR, DFAR, CAS and any contract specific stipulations.

Once this document is filed you are required to “true-up” your cumulative provisional billings to the government for each project to your final actual cumulative costs contained in the submission. One important condition for an adequate accounting system is that it provide for progress billings to be reconciled to the final cost accounts for both current and cumulative amounts claimed.

The annual incurred cost submission has a 100% chance of being audited by DCAA. Some good news — DCAA will perform a risk analysis and may cycle your audits between full-blown live audits and desk audits.

**One final thing to be aware of.**

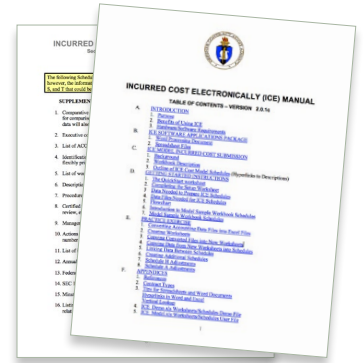
Most cost reimbursable contracts are for a significant amount of funding. As such, they will also contain FAR clause 52.242-3, which is referred to as the penalty clause. If the penalty clause is in place and DCAA audits the incurred cost submission and finds a specifically unallowable expense, or a questioned cost that has been disallowed in a prior year, they will not only disallow the expense, but will also assess a 100% penalty - a double whammy!

One prospective client contacted us to see if we could help them when their controller (who they thought understood government contracting) claimed several hundred thousand dollars of a specifically unallowable expense in their incurred cost submission. Several years later, after the incurred cost audit was complete and DCAA disallowed the expense, the company was forced to lay off several employees, including the controller. Upon appeal, the government ruled that not knowing the rules, or relying on someone who doesn’t know the rules is not an acceptable excuse and enforced the large penalty.

Contract Close Out



While not technically an audit, you should understand that until the contracting officer formally closes your contract, your organization continues to be subject to the terms and conditions of the award — and you still may have financial exposure.



**ANNUAL INCURRED COST SUBMISSION SAMPLE**





## STAYING OUT OF TROUBLE

The inter-relatedness of all the reports and documents that DCAA receives and audits cumulatively over time is important to consider. At [Jameson](#), we've created proprietary internal procedures for all our clients' reporting requirements to anticipate potential issues that may be scrutinized. Then, we take steps to proactively educate and prepare our clients before any filing, making sure that they're taking steps to mitigate any potentially significant risks. Our thirty plus years of experience in this area of accounting empowers our specialists to anticipate an auditor's concern and respond as succinctly as possible.

### How to Manage Your Risk

As experts in government award accounting, with over 30 years of experience, clients from coast-to-coast, and over \$4 billion in awards managed, we know the DoD, DCAA, and the regulations, and how to help you avoid the pitfalls. We also know how to help you manage risk in accordance with your business goals.

### Find Out if You Qualify for a **FREE RISK AND COMPLIANCE ANALYSIS**

These insights can help you better manage your award and avoid the peril of an audit. For details, contact Ryan at 781-862-5170, ext. 2106 or email [ryan@jamesoncpa.com](mailto:ryan@jamesoncpa.com). It could be a game-changer.



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**Jameson & Company** CPAs delivers proven accounting services custom designed for entrepreneurs who have been awarded Federal contracts and grants with annual revenues of up to \$10 Million. We provide the skills and processes you must have to maintain a FAR compliant accounting system. We've successfully represented clients during thousands of DCAA audits, NIH indirect rate negotiations and audits by other government agencies. We manage your accounting system so you have more time to innovate. We've helped clients manage over \$4 billion in Federal awards – fairly, cost effectively, from coast to coast.