The Defense Contract Audit Agency (DCAA) is charged with verifying compliance of the financial systems for contractors working for the Department of Defense. However, there are many different ways, and many different elements of a business the DCAA is required to examine. In this tutorial we will provide a brief summary of the different kinds of audits DCAA conducts including: (1) Pre-award audits; (2) Post-award audits; and (3) Contractor business system audits.

THREE TYPES OF AUDITS

With a Pre-award audit the focus is on items such as price proposals, forward pricing, and indirect rates. All of these could be subject to audit. For firms having a cost-reimbursement contract for the first time, the pre-award accounting system survey is one of the most important financial hurdles to overcome.

During Post-award, a common audit is an Incurred Cost audit. This is required with Cost Reimbursable type contracts, where you’ll need to report your year-end actual incurred costs to the government. Other post-award audits may include those for Truth in Negotiations compliance, Cost Accounting compliance, audits of contract changes and other claims, as well as labor floor check audits.

Fortunately, there are audit types that will not apply to you as a small business such as the audit of your Cost Accounting Standards, or CAS, disclosure statement. There are thresholds for having a CAS-covered contract that requires a more rigorous documentation of your accounting system. However, small businesses are exempt from certain CAS requirements so you don’t need to worry about this type of audit which can be rather long and rigorous. In addition, defective pricing and change order audits are unheard of in the SBIR/STTR realm, but we’ll touch on those briefly since small businesses could be exposed to those when they graduate to non-SBIR/STTR contracts.

Interaction with DCAA regarding Phase I SBIR/STTR proposals is quite limited as these are usually firm fixed price contracts. There is no pre-award accounting system survey required for any firm fixed priced awards, and scrutiny of proposal pricing, in most cases, is manageable, as long as it’s less than $750,000. Once you receive a Phase II award your interaction will become more complex as the awards are often cost reimbursement type awards. DCAA involvement in Phase II will include a pre-award survey and pricing scrutiny, post-award accounting system audits, and incurred cost audits during the performance of your Phase II. Often, this level of interaction comes as a surprise to new awardees. It’s a little daunting when faced with this for the first time. So when bidding on a Phase II, it’s important to anticipate this level of interaction with DCAA.
What’s the purpose behind the additional rigor to the review process? It’s the government’s way of setting fair prices while balancing the financial and performance risks of the contractor and the ultimate customer, the taxpayer.

The first encounter with a DCAA auditor or other government audit official occurs during the government’s review of proposal pricing, even if the expected contract is fixed price. Requirements for cost and pricing proposal data are contained in FAR Table 15-2, with proposal data submitted for non-commercial contracts over $750,000 requiring what’s called “certified cost and pricing data.” It may be surprising to most that the concepts that apply to the pre-award accounting system survey, to be discussed later, will be used by the government to evaluate virtually all proposals, even those less than $750,000. Many contractors struggle in this pre-award phase, since they may have their own ideas on how to price their efforts which may conflict with the government’s method.

BASIC PRINCIPLES

All pricing must follow the three basic principles of government cost accounting: Allowability, Reasonableness, and Allocability. The government is transparent about what costs they will not pay for, and what costs they will pay for under certain conditions. This list can be found a FAR 31.205. Even if your costs pass the test for allowability, the pricing must also be considered reasonable, as defined in FAR 31.201-3 as, “in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business.” It’s fair to say many auditors may not see eye-to-eye with contractors when evaluating the reasonableness of costs.

The concept of allocability is a bit more complex, since costs are classified according to any number of attributes. Take shipping costs, for example - they may be classified as project, or direct costs, or they may be collected in an indirect cost pool, such as overhead. Either way may be correct depending upon whether this approach is consistently applied and represents a fair allocation of costs.

When evaluating contractor proposals, scrutiny is applied to project costs in a different manner than indirect rates. Much of the focus for project costs relates to labor in the form of reasonable salary, the hours estimated, and the mix of labor. Another focus is on non-labor project costs such as subcontracts and materials. Bear in mind that different agencies have specific allowability rules for project costs. Proposal auditors and reviewers in all cases will want evidence of competitive pricing for large, non-commercial subcontracts and material quotes, or a valid justification for selecting a single source.

Indirect rates are a different matter. Proposed rates for small businesses should consist of a customary and meaningful structure, such as an Overhead and G&A (General & Administrative) rate approach. A single indirect rate, where all indirect costs are divided by direct costs, is also a suitable approach, especially for new SBIR/STTR firms. Whatever indirect rate structure you choose, the government will expect to see calculations behind the rates proposed, along with your ability to justify both the indirect rate structure and the indirect rates themselves. The government may even assist you by providing models for you to calculate your indirect rates. While the intent is helpful, it’s always a good idea to have someone validate these models who is knowledgeable with calculating indirect rates.
Forward Pricing Proposals are typically reserved for larger contractors having long-term delivery contracts. SBIR/STTR and other small businesses should not expect to be asked to submit and negotiate Forward Pricing Proposals. However, we have seen some DoD entities request five year budgets comprising one base period and four option years. While not technically Forward Pricing Proposals, these proposals may require similar pricing techniques such as labor escalation factors and annual indirect rate projections. In any case, these proposals would be still be reviewed by the government in accordance with the aforementioned FAR Table 15-2.

**COST-REIMBURSEMENT CONTRACTS**

The largest hurdle for a contractor new to cost-reimbursement contracts, such as a DoD Phase II SBIR or STTR, is passing the pre-award accounting system survey. This may be formally called a survey, but it feels more like an audit of your accounting system and a review of how it is designed to accommodate cost-plus type contracts. The DCAA will follow their checklist for compliance, called the SF1408 form. This form lists 14 attributes of a compliant accounting system which the DCAA will ask you to demonstrate. They will also want to review policies and procedures for operating the accounting system relative to many of these attributes.

Chief among these attributes are:

1) The ability of the accounting system to segregate direct project costs from indirect costs.
2) The ability to further segregate direct costs by project
3) Implement a labor timekeeping and cost distribution system that accurately assigns labor costs to projects or as indirect.

In the past, DCAA auditors had some leeway in accepting accounting systems with minor deficiencies contingent upon the contractor’s immediate corrective actions. Today, the SF1408 process is pass/fail, making the pre-award accounting system survey a critical element to contracting success. The best strategy is to start planning for passing this audit when you receive your Phase I award. This is the expectation, even if this government contract is your firm’s only project.

After passing the pre-award accounting survey and getting an SBIR/STTR Phase II award, you’ll need to start thinking about submitting a Provisional Billing Rate Proposal to the DCAA. This will be very similar to the indirect rates you calculated and negotiated as the basis for the award. FAR 42.704 describes the process for establishing annual indirect billing rates. These rates are submitted to and negotiated with the DCAA to be used in billing project costs to the government.

In theory, your indirect rates will fluctuate month to month on a cumulative basis. Having fixed billing rates is convenient for both parties, avoiding adjustments for every bill due to indirect rate variations. Fortunately, the government will have already seen these or similar rates during the proposal phase, so review by the DCAA should be swift. The Provisional Billing Rate proposal is due to the DCAA every year at the beginning of the year in order to either validate that billing rates should not change, or to propose new ones. In the next tutorial we will introduce the Incurred cost audit – which is one of the most important post-award audits.