



## THE DCAA AUDIT

Created to oversee government spending on behalf of the American tax-payer, the Defense Contract Audit Agency (DCAA) is responsible for supervising all Department of Defense (DoD) contracts. DCAA audits monitor the aggregate of contractor business operations to ensure that all incurred costs are accurately assigned and accounted for, reducing federal waste and securing equal treatment for DoD contractors.

*The DCAA Contract Audit Manual (CAM) states the general audit objective as follows:*

Audit interest encompasses the totality of the contractor's operations. Audits are performed to assure the existence of adequate controls which will prevent or avoid wasteful, careless, and inefficient practices by contractors. These audits include the evaluation of a contractor's policies, procedures, controls and actual performance, identifying and evaluating all activities which contribute to, or have an impact on, proposed or incurred costs of Government contracts. <sup>(1.)</sup>

The audit is a comprehensive check on contractor operations, examining each process relevant to the DoD contract. So what does this mean for your company? If you're ever going to pursue a contract with the DoD, you'll need to be prepared for a DCAA audit. This doesn't just mean that every cost must be recorded, described, assigned, and supported; the contractor must maintain rigorous records and controls for every discrete level of operation. To secure a DoD contract, an aspiring contractor must therefore demonstrate an extremely high level of accounting capability as well as a substantiated capacity to fulfill the contract's objectives.

## BECOMING DCAA COMPLIANT

So what must a company do to satisfy the requirements of a DCAA audit? Essentially, the audit is concerned with identifying and evaluating any activity either directly or indirectly affecting proposed or incurred costs of Government contracts. An ambiguously large operational array, this necessarily includes all of the contractors' financial policies, procedures, and internal controls.

The DCAA audit focuses on the adequacy of a contractor's policies, procedures, practices, and internal controls relating to accounting, estimating, and procurement. Audits further inspect the accuracy and reasonableness of cost representations, the adequacy and reliability of a contractor's records for Government-owned property, the financial capabilities of the contractor, and the appropriateness of contractual provisions having accounting or financial significance. <sup>(2.)</sup>

Though this all sounds daunting, securing a comprehensive financial and timekeeping system will make DCAA compliancy a relative non-issue. With well-followed and consistent accounting procedures established in full, traceable, and readily accessible, a company should have little difficulty surpassing DCAA requirements.



## A NOTE OF WARNING: INCREASED DCAA RIGOR

Following a congressional examination in 2008, the DCAA has been required to implement significant procedural changes. The Senate committee in charge of the examination determined that audits were being completed too quickly and frequently resulted in serious errors. The committee also criticized DCAA supervisors for overriding auditor findings and recommendations, cracking down on the audit completion process and making it more difficult for contractors to receive a passing grade. As a result, the DCAA has been pursuing audits with greater scrutiny and is following FAR, CAM, and GAGAS regulations in greater detail. Heightened DCAA scrutiny is already evidenced by the number of audits completed since the end of the congressional examination. In 2007, the DCAA completed 25,547 audits, a figure consistent with previous years. In 2009 this number had dropped to 16,213, and in 2010 the number of completed audits fell even further to 11,746. Though the DCAA now audits fewer contractors, compliance is more difficult to achieve.<sup>(3.)</sup>

Contractors can also no longer pass a DCAA audit without meeting all of the stated requirements. No longer issuing degrees of completion or recommendations for change, the DCAA now provides only passing or failing grades during an audit. Contractors have no choice but to become fully DCAA compliant in order to successfully complete a DoD contract.

## TRACKING LABOR

Labor is often the highest expense in defense contracts, making a robust labor management system essential for all DoD contractors. The DCAA's *Information for Contractors* states that "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."<sup>(4.)</sup> While tangible materials are simple enough to track, allocate, and price, recording and assigning labor hours can be a demanding process for which many contractors' systems may be insufficient.

Recorded labor hours are not only essential to accurate billing reports but provide foundational information for declaring costs and creating accurate project estimations. These elements are all crucial to the audit process at every stage, and tracking employee hours and determining labor costs are imperative to satisfying all DCAA audit requirements.

The DCAA requires that all employee hours be furthermore broken down by distinct tasks. This shows exactly where time has been allocated in order to properly track project progression and appropriately assign costs. The procedures used for tracking time need also be evident, clear-cut, and reasonable in their completion to ensure consistent usage. Furthermore, companies must be persistent in enforcing time-tracking methods by all employees. The effectiveness of the timekeeping system is contingent upon full user adoption and is absolutely essential for DCAA compliancy.

To measure effectiveness and consistency in labor recording, DCAA auditors enact up to two random floor checks per year. In such instances, auditors meet with employees and monitor activity to ensure that employees are actually at work, that employees are performing the jobs described, and that employee time is being charged to the appropriate job or account.



## PREPARING FOR A DCAA AUDIT

The most effective way to prepare for a DCAA audit is to standardize company accounting procedures and employ a comprehensive system for tracking and recording employee time long before the audit process initiates.

Accounting and timekeeping software is crucial to passing even the preaward survey of the DCAA audit. Companies capable of demonstrating a history of comprehensive accounting and time management practices often experience minimized oversight throughout the audit process. Contrarily, contractors with less established practices for recording costs, tracking and allocating materials, billing, and monitoring labor undergo a more wearisome audit experience. If a company's accounting software proves incapable of handling DCAA mandated rigor, a comprehensive review of the company's manual system will be required.

If that isn't enough of an incentive on its own, the DCAA issues serious penalties for companies who fail to enact sufficient record keeping systems in time.

Establishing compliant practices early on can save a considerable amount of money and tumult down the road.

## THE DCAA SYSTEM EVALUATION LETTER

The following letter is an example of the DCAA notification letter preceding a preaward audit. It establishes the auditor's intentions and lays out the areas of inspection.

Dear Contractor,

This letter is to advise you we are initiating an audit relating to Contractor's accounting system as a result of proposal F2-77.5104.88. Specifically, DCAA has been requested to perform a pre-award accounting system evaluation to determine whether your accounting system is adequate according to Federal Acquisition Regulations (FAR) for award of future government contracts. In conjunction with our audit, it is requested that the following data and records be assembled and made available for our audit field visit.

1. Most recently completed fiscal year prepared financial statements and associated notes.
2. Most recently completed monthly financial statements (to include Statement of Stockholders' Equity, Balance Sheet, Income Statement, and Statement of Cash Flows).
3. Year to date Trial Balance.
4. Year to date Chart of Accounts.
5. Identify the general ledger account codes for each indirect expense that make up your indirect cost pools and each expense account that makes up your allocation bases.
6. Detailed computations for each year to date indirect rate.
7. Most current month's Job Cost Subsidiary Ledger.
8. Identification of general ledger accounts used to collect unallowable costs.



9. Policies and procedures pertaining to the following:
  - a. Identification of direct and indirect costs.
  - b. Describing how costs are accumulated by contract.
  - c. Describing the indirect costs, indirect cost pools, and the allocation bases.
  - d. Application of overhead to the job cost ledger, if applicable.
  - e. Describing the establishment of provisional billing rates based on annual forecasts at the beginning of the year.
  - f. Describing how often you monitor interim provisional billing rates to preclude significant over/under contract billings of costs.
  - g. Describing in regards to actual indirect rate determination and incurred cost submission at year end.
  - h. Billings adjustments after the final indirect rates have been established.
  - i. Describing whether a job cost ledger is used as a basis for billings on contracts.
  - j. Describing system of recording labor hours, ensuring they are recorded in the labor distribution report and reflected in the job cost ledger and general ledger trial balance.
  - k. Written policies and procedures for posting costs to the job cost general ledger, if available.
  - l. Identification and removal of FAR 31 unallowable and directly associated costs from the contract and from the indirect costs pools which are allocated to contracts.
  - m. Training to accounting personnel in regards to unallowable costs.
  - n. Budgetary and cost monitoring controls to ensure contract performance can be accomplished within the contractual cost ceiling.
  - o. Notification to the contracting officer in the event that total costs will be significantly different from the estimated costs.
  - p. Description of timekeeping system.
10. Accounting system description with an overview of the system and a description of the major subsidiary books of account; including a description of what ledgers are fully integrated into the accounting system and what systems are manual in part.
11. Current employee listing.



## PASSING THE PREAWARD SURVEY

The preaward survey is the first step toward securing a DoD contract. In this stage, the DCAA determines whether a contractor is both capable of meeting the objectives of the contract and able to accurately track its resources. Though it isn't necessary for the contracted company to employ a passable accounting system at the time of the survey, there must be evidence of a transition to a more capable system prior to the contract's start date.

Preaward surveys cover process definitions, technical ability, production capacity, financial controls, quality assurance, accounting system capabilities, and several other considerations. Many of these categories can be approved in a clear-cut manner – technical ability and production capacity, for example, cannot be disputed – yet accounting system capacity is more ambiguously defined and tends to dominate the preaward survey process.

Critical to an accounting system's functionality is the ability to segregate tasks and identify labor by intermediate or final cost objectives. All accrued expenses need be similarly separated between direct and indirect costs for the accounting system to pass muster with the DCAA. The recording process must not only be systemized, but furthermore requires effective checks from information tampering or inputting incorrect data. Accurate controls and recording standards are critical to the time-keeping process.

## PRICE PROPOSALS

The DCAA reviews all price proposals for a contract to ensure accuracy. Contractors must provide evidence for how estimates were achieved in order to justify the fidelity of these figures. Though certain prices are commonly subject to judgmental factors, these estimates must be backed by correlating evidence.

To prove the accuracy of price proposals, companies must often provide evidence for how labor rates were estimated, the basis for proposed labor categories and hours assigned to each, and a comparison of proposed hours to experienced hours for similar items. Contractors should possess a solid foundation of relevant information and a proven system for deriving project estimates in order to thoroughly satisfy DCAA demands. Complex labor analysis, project duration, and resource allocation should all contribute to the eventual product.

DCAA auditors will then perform a Cost Realism Analysis of the proposed budget to decide whether or not predicted prices are under- or overstated. The DCAA attempts to avoid any situation where DoD contracts either run over budget or under budget, as both options mandate the payment of unnecessary funds.



## CONTRACT FINANCING AND INTERIM (BILLING) METHODS

Companies must be able to provide updated billing information at least monthly to the DCAA. This proves that the contractor maintains cumulative allowable costs by contract to support the preparation of interim and final vouchers.

*Information for Contractors* states that "cumulative costs are necessary to assure that the cumulative amounts billed do not exceed the total estimated ceiling costs on the contract and/or the current contract maximum funding levels."<sup>(5.)</sup>

Contractors must possess the flexibility to provide consistently updated and modified billing records, with proper allocation of materials and labor, as evidence of their ability to satisfy demand and remain on budget. Billings must also be updatable to demonstrate either the additional amount due to the contractor if the billing rates are lower than actuals or credit due the Government if the actual rates are lower. Contractors desiring to be fully compensated for their work must be able to demonstrate need through accurate billing records and continuously meeting the demands of the DCAA.

## INCURRED COST PROPOSALS

Contractors are responsible for recording and maintaining records of additional incurred costs throughout the duration of the project to claim any reimbursement. Companies must make every effort to identify all costs, both direct and indirect, toward the project's completion. Contractors must also distinguish all tasks and expenses between direct and indirect costs, as well as clearly defining overhead costs against all others. Auditors will then deem whether costs are reasonable, allocable to the contract, in accordance with the generally accepted accounting principles and Cost Accounting Standards, and allowed by the contract.



## ADDITIONAL DCAAMATERIAL

### DCAA Accounting System Audit Checklist

The DCAA accounting system evaluation checklist examines a contractor's ability to perform the following:

The accounting system complies with Generally Accepted Accounting Principles.

The accounting system provides for:

- Proper segregation of direct costs from indirect costs
- Identification and accumulation of direct costs by contract.
- A logical and consistent method for the allocation of indirect costs to intermediate and final cost objectives.
- Accumulation of costs under general ledger control.
- A timekeeping system that identifies employees' labor by intermediate or final cost objectives.
- A labor distribution system that charges direct and indirect labor to the appropriate cost objectives.
- Interim (at least monthly) determination of costs charged to a contract through routine positing of books of account.
- Exclusion from costs charged to government contracts of amounts which are not allowable in terms of FAR 31, Contract Cost Principles and Procedures, or other contract provisions.
- Identification of cost by contract line item and by units (as if each unit or line item were a separate contract) if required by the proposed contract.
- Segregation of preproduction costs from production costs.

The accounting system is designed to maintain adequate, reliable data with preventions from tampering.

The accounting system is either currently in full operation or on schedule to be adopted.



## DCAA INTERNAL CONTROL QUESTIONNAIRE

The following information is taken from the *Survey of Contractor's Organization, Accounting System and System of Internal Controls (ICQ)*. This survey provides the basis for documenting the auditor's understanding of the contractor's internal control components. It focuses on five internal control components: control environment; contractor's risk assessment; information and communications; monitoring; and accounting system.

### Control Environment:

1. Does management promptly correct deficiencies noted in external CPA's management letter on internal controls and in DCAA internal control audits?
2. Does the contractor maintain written policies and procedures to describe:
  - a. The assignment of authority and areas of responsibility so that there is adequate segregation of duties.
  - b. The general accounting system.
  - c. Identification and exclusion of unallowable costs.
- d. Direct/Indirect charge practices.
  - e. Preparation of incurred cost submissions and forward pricing proposals.
  - f. Allocation of indirect costs to final cost objectives.
  - g. Approval and documentation of journal entries.
  - h. Establishment of account numbers.
  - i. Approvals for establishing contract charge numbers.
  - j. Allocation of income, rebates, refunds, allowances or other miscellaneous credits.
3. Are the contractor's cost accounting records reconciled to and controlled by the general accounting system on a current basis, i.e., postings are made at least monthly?
4. Does the contractor's system identify costs by contract (e.g., job cost ledger)?

## CONTRACTOR'S RISK ASSESSMENT:

1. Does the contractor have a risk assessment process for identification, analysis, and management of risks relevant to the preparation of submissions to the Government in accordance with Federal Government regulations?
2. Has any current or previous assignment identified the contractor's failure to properly assess the risk of having noncompliant submissions?
3. Has any significant change in accounting for costs within the contractor's current and preceding two years?
  - a. Allocation of indirect costs - Structure of the indirect overhead rates (pool or base costs)?
  - b. Accounting for direct costs?



## INFORMATION AND COMMUNICATIONS:

1. Does the contractor have written policies and procedures for the IT system that include appropriate manual and computerized control procedures to:
  - a. initiate, record, process, and report the contractor's transactions and journal entries (as well as events and conditions) from their occurrence to their inclusion in the accounting records;
  - b. enter transaction totals into the general ledger;
  - c. record recurring and nonrecurring adjustments or reclassifications if they are not recorded through formal journal entries?
  - d. convert hard-copy documents to electronic medium (if applicable)?
2. Do the contractor's policies and procedures address the individual roles and responsibilities pertaining to internal controls over accounting information?
3. Does the contractor disseminate its policies and procedures to its employees?
4. Has any current or previous assignments identified the contractor's failure to properly implement any of these internal control procedures?

## MONITORING:

1. Does the contractor have ongoing monitoring procedures and/or separate internal control reviews/audits to ensure that internal controls are operating as intended and that they are modified as appropriate for changes in conditions?
2. Has any current or previous assignment identified the contractor's failure to monitor the effectiveness of internal control procedures?



## ACCOUNTING SYSTEM:

1. Does the contractor have a training program to reasonably assure that all employees are aware of the importance of proper time charging?
2. Do the contractor's written policies and procedures provide labor documentation/work descriptions that identify the work to be performed, and are labor charges tracked to a final cost objective, whether allowable or unallowable/direct or indirect?
3. Does the contractor maintain written timekeeping policies and procedures to reasonably assure that labor hours are accurately recorded and corrections are documented, including authorizations and approvals?
4. Does the contractor maintain written policies and procedures to describe the major manual and automated systems that comprise the material management and accounting system?
5. Does the contractor have written estimating policies and procedures to address employee training, assignment of authority and responsibilities, cost estimate development, and the estimating system process, activities, and functions?
6. Does the contractor have and disseminate written billing policies and procedures which address employee training, contract briefing to identify special billing provisions and limitations, and management review of billings?
7. Does the contractor have written policies and procedures for the planning and budgeting system, which include the formal assignment of duties and responsibilities and a description of the system?
8. Do written policies and procedures for compensation exist to include:
  - a. a salary structure and administration;
  - b. a description of fringe benefits provided to employees; and
  - c. a system for determining pay increases, bonuses, and promotions?

- (1.) Defense Contract Audit Agency, DCAA Contract Audit Manual, Section 1-104.2.a, <http://www.dcaa.mil/>
- (2.) Defense Contract Audit Agency, DCAA Contract Audit Manual, Section 1-104.2.a, <http://www.dcaa.mil/>
- (3.) <http://www.bizjournals.com/washington/blog/2010/11/backlog-at-dcaa-results-in-fewer-audits.html/>
- (4.) Defense Contract Audit Agency, Information for Contractors, Section 2-302, <http://www.dcaa.mil/dcaap7641.90.pdf>
- (5.) Defense Contract Audit Agency, Information for Contractors, Section 5-301.1.c, <http://www.dcaa.mil/dcaap7641.90.pdf>