



## **DCAA Audit and Compliance Strategies**

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ARTICLE

### Contracting Regulations for Small Businesses

Expanding your business into the federal marketplace can be lucrative, and provide numerous networking and growth opportunities. But be warned: Winning a federal contract also means complying with laws and regulations unique to those doing business with the government. Many new contractors, especially small businesses, are unprepared for the rules and regulations they must follow, which can lead to costly errors and potential legal problems. The resources below will help you become familiar with the regulations that apply to most federal contractors.

#### Procurement Regulations

The Federal Acquisition Regulation (FAR) is a substantial and complex set of rules governing the federal government's purchasing process. Its purpose is to ensure purchasing procedures

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## Who is DCAA?

The Defense Contract Audit Agency, operates under the authority, direction, and control of the Under Secretary of Defense (Comptroller), (USD(C)) / Chief Financial Officer (CFO), Department of Defense.

### DCAA Regional Boundaries





### **Governing Regulations**

The DCAA Contract Audit Manual (CAM) provides extensive additional information on audit policies and procedures. The DCAA Pamphlet 7641.90, *Information for Contractors*; DCAAM 7640.1; CAM, and current audit guidance (not incorporated into CAM) are available on DCAA's web site at [www.dcaa.mil](http://www.dcaa.mil). Other acquisition reference materials can be found on the Defense Acquisition University's (DAU's) Acquisition, Technology and Logistics' Knowledge Sharing System (AKSS) web site at <http://akss.dau.mil>.





### **FAR Cost Principles**

FAR Part 31 - A chronology that is used to determine the cost principles in effect at time of contract award that may be necessary for audits of historical costs. It can be found at [www.dcaa.mil](http://www.dcaa.mil)

## Audit Emphasis



- (1) internal control systems & management policies,
- (2) accuracy and reasonableness of cost representations,
- (3) adequacy and reliability of records/accounting systems,
- (4) financial capability, and
- (5) contractor compliance with contractual provisions such as CAS and the Truth in Negotiations Act.

The extent of DCAA's involvement is determined by the type of contract that will be awarded. Generally, most DCAA efforts on firm-fixed price type contracts take place during the proposal stage rather than in the incurred cost stage. The reverse is true for flexibly priced contracts.

## **Defining Cost Structures**

**Direct costs** are defined in FAR 31.202 as any cost that can be identified specifically with a particular final cost objective (e.g., a contract). An example would be labor specifically identified to the contract, or materials purchased specifically for the contract.

**Indirect costs** are defined in FAR 31.203 as any cost not directly identified with a single, final cost objective, but identified with two or more final cost objectives or an intermediate cost objective.

### **Overhead Costs**

Costs that are incurred for or that only benefit an identifiable unit or activity of the contractor internal organization such as a engineering department are considered overhead costs. It is common to find separate overhead pools for engineering, manufacturing, material handling, and for certain off-site activities.



## Defining Cost Structures

Examples of overhead pool costs are:

- Department supervision
- Training of department employees
- Fringe benefits of department employees



### **G&A Cost**

G&A expenses represent the cost of activities that are necessary to the overall operation of the business as a whole, but for which a direct relationship to any particular cost objective cannot be shown. G&A includes the top management functions. Typically, it includes human resources, accounting, public relations, contract administration, legal, etc.

## Defining Cost Structures

**Facilities Capital Cost of Money** (cost of capital committed to facilities) is an imputed cost. It is allowable whether or not the contract is otherwise subject to cost accounting standards (CAS).

### **Other Indirect Cost Pools**

- IRAD
- Bids & Proposals
- Manufacturing Overhead
- Fringe Benefits



## **Defining Cost Structures**

### **Unallowable Expenses**

Expenses that are legitimate business expenses however are not allowed on government contracts. Examples include:

- GSA IFF Fees
- Federal Taxes
- Interest Expenses
- Donations
- Penalties & Fines
- Employee Morale

### **Uncompensated Overtime**

It the unpaid hours worked over the standard 40 hours for exempt FAR 52.237-10 requires that all hours worked are recorded whether paid or not. This is necessary because labor costs and overhead are affected by total hours worked.

## **Accumulation of Direct & Indirect Costs**

### **a. Proper segregation of direct from indirect costs.**

DCAA will review the accounting system to determine if direct costs are segregated from indirect costs.

Indirect costs are normally placed in an overhead or general and administrative (G&A) expense pool and allocated to contracts on some equitable basis. Once these criteria are defined, they must be consistently applied.



## **Accumulation of Costs**

### b. Identification and accumulation of direct costs by contract.

DCAA will determine if the accounting system can accumulate costs by contract (commonly referred to as a job order cost accounting system).

c. A logical and consistent method for the allocation of indirect costs to cost objectives. DCAA will determine if indirect costs are allocated to cost objectives based upon relative benefits received, or other equitable relationship. Fundamentally, this means that a cost may not be allocated as an indirect cost to a final cost objective if other costs incurred for the same purpose have been included as direct costs of that or any other cost objective.

### Accumulation of Costs

d. Accumulation of costs under general ledger control. DCAA will determine if the job order cost accounting system can be reconciled with the general ledger, and that the company accounting system is controlled by the general ledger.

e. A timekeeping system that identifies employees' labor by cost objectives. DCAA will determine whether a contractor's timekeeping system has the ability to track employees' time spent on each work activity.



## Accumulation of Costs

f. A labor distribution system that charges direct and indirect labor to the appropriate cost objectives.

Once an employee's time is segregated, the costs must be allocated to the appropriate cost objectives.

g. Interim (at least monthly) determination of costs charged to a contract through routine posting to books of account.

DCAA will determine if the accounting system produces appropriate reports that show the results of charges to contracts. These reports should be produced at least monthly.

## Accumulation of Costs

h. Exclusion from costs charged to Government contracts of amounts that are not allowable pursuant to FAR Part 31 or other contract provisions.

The FAR identifies some costs as expressly unallowable: e.g., bad debts, contingencies, donations, entertainment, etc and requires that they be excluded from proposals and billings. While these costs may be legitimate business expenses, they will not be accepted by the U.S. Government as allowable contract costs. FAR 42.709 authorizes contracting officers to assess a penalty if a contractor claims an expressly unallowable cost



## Accumulation of Costs

i. Identification of costs by contract line item and units (as if each unit or line item was a separate contract) if required by the proposed contract. Some contracts require that the cost of certain items be readily identifiable. In such cases, DCAA will review a contractor's accounting system to determine if a contractor can comply with such requirements.

j. Segregation of pre-production costs from production costs. DCAA will review a contractor's accounting system to determine that the costs can be identified in this manner.

## Accounting System & Labor Evaluations

### Pre-award Surveys of Contractor Accounting Systems

-Financial capability audits are performed to determine if the contractor is financially capable of performing on Government contracts. Reports including financial statements, lending institutions, SEC filings, cash flow forecasts, loan agreements, aging of accounts receivable and payable, financial history of the contractor and affiliated concerns, and payroll tax returns.

The pre-award accounting system survey is to determine the acceptability of the accounting system for **accumulating costs** under a Government contract.



## **QuickBooks Setup Basics**

### Compliant Chart of Accounts

- Standard Balance Sheet Accounts
- COGS (tracking direct costs, project related)
- Most common indirect cost pools
  - Fringe (use all productive labor as the base)
  - Overhead (use direct labor as base)
  - General & Administrative (use total cost input as base)
- Unallowable Costs (FAR Part 31.205)

Indirect Costs – Approved Structure from DCAA is a minimum of 3 Rate Structure – Fringe, Overhead, and G&A pool. The G&A Pool can be further divided into sub pools – Facilities, Sales & Marketing, Finance & Admin, Bids & Proposal, Independent Research & Development.

## QuickBooks Setup Basics

### Direct Cost Items



All Items in this list will map to the Cost of Good Sold account. Hence the Items will match the COGS accounts.

Customers/Jobs are created using a Project Code Legend. Use a sequential system to track jobs in QuickBooks. For example:

1<sup>st</sup> Digit = Procurement type

2<sup>nd</sup> Digit = Customer Code

3<sup>rd</sup> & 4<sup>th</sup> Digits = Contract awards within customer

5<sup>th</sup> thru 7<sup>th</sup> Digits = Subtask

## QuickBooks Setup Basics

### Payroll Items

All Wages will be setup as Hourly Wages for DCAA purposes. Payroll Items will need to be setup for Direct, Overhead, and all G&A wages categories. Uncompensated Wages will also be setup under both Overhead and G&A categories

Employee Setup will involve assigning employee wages to specific payroll item accounts. Payroll Items are mapped to GL accounts.

\*\*QuickBooks is not a DCAA Approved Compliant System. However the correct setup of the system can derive acceptable reporting for DCAA.

## QuickBooks Setup Basics

### Job Cost Ledger & General Ledger

These reports can be extracted from QuickBooks Report menu – Click on Profit & Loss by Job, and General Ledger under Accountant & Taxes.



## Review Accuracy

- Profit & Loss should tie to Job Cost Ledger
- Profit & Loss should tie to the Payroll Summary total
- Payroll summary should tie to the Time by Name report
- Vacation payroll Item should be set up to accrue on the Balance Sheet



## Accounting System & Labor Evaluations

### Labor Charging System

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. It is critical to labor charging internal control systems that the management indoctrinates employees on their independent responsibility for accurately recording time charges.

- Segregation of Responsibilities
- Procedures
- Maintenance of Controls
- Employee Awareness





## Accounting System & Labor Evaluations

### Time Card Compliance

Detailed instructions for timecard preparation should be established through a timekeeping company procedure.

- Recording his/her time on a daily basis.
- Recording time on the timecard in ink.
- The correct distribution of time by project numbers, contract number or name for a particular assignment.
- Changes to the timecard should be lined through, with the employee's initials beside the change.
- Recording all hours worked whether they are paid or not.

This is necessary because labor costs and overheads are affected by total hours worked, not just paid hours worked. Unpaid hours worked are termed "uncompensated overtime."



## **Accounting System & Labor Evaluations**

### **Time Card Compliance**

- Signing the timecard at the end of each work period.
- The supervisor should approve and cosign all timecards.
- The supervisor is prohibited from completing an employee's timecard unless the employee is absent for a prolonged period of time on some form of authorized leave.
- The guidance should state that the nature of the work determines the proper distribution of time, not availability of funding, type of contract, or other factors.
- The company policy should state that the accurate and complete preparation of timecards is a part of the employee's job.

## **iRapt, ICE, and PBR**

### **Submission of Vouchers (Invoices)**

If DCAA determines that a contractor is eligible to participate in the direct billing program, the contractor will be authorized to submit interim vouchers directly to the designated Government paying office, based on a DCAA authorization memorandum.

A contractor that participates in the direct billing program may be eligible to submit vouchers electronically via the DFAS paperless initiatives. DFAS allows contractors to submit vouchers electronically via Electronic Data Interchange (EDI) or Invoicing Receipt Acceptance & Property Transfer (iRapt/WAWF).

The electronic submission of interim vouchers by contractors participating in the direct billing program does not require the submission of a SF 1034 or 1035.

**PUBLIC VOUCHER FOR PURCHASES AND  
SERVICES OTHER THAN PERSONAL**

VOUCHER NO  
(b) 307  
SCHEDULE NO  
(c)  
SHEET NO  
(d)

**CONTINUATION SHEET**

U.S. DEPARTMENT OF COMMERCE  
(a) Navy Regional Medical Center, San Diego, CA

NUMBER AND DATE OF ORDER	DATE OF DELIVERY OR SERVICE	ARTICLES OR SERVICES <i>(Show description, item number of contract or Federal supply schedule, and other information deemed necessary)</i>		QUANTITY	UNIT PRICE		AMOUNT
					ODM	PER	
(e) XYZ Corporation 208 Euclid St. Tampa, Florida 20005		(f) Contract No. N66818-91-C-0091					
		(h) Contractor's Cumulative Claim Reconciliation Statement		(g) Target/Estimated Costs			\$400,000
				(g) Fixed Fee			36,000
				(g) Total			\$436,000
(j) Final Rates		FY 87	FY 88	FY 89	(k) Total		
Fringe Benefit Rate		10.93%	12.15%	13.33%			
Overhead Rate		112.99	92.30	92.12			
G&A Rate		2.91	14.97	12.33			
(i) Major Cost Elements							
Salaries		\$115,572.17	\$ 16,068.11	\$1,033.44			\$134,673.72
Fringe Benefits		12,632.04	1,952.28	404.36			14,988.68
Total Direct Labor		\$128,204.21	\$ 18,020.39	\$1,437.80			\$149,662.40
Overhead		\$144,857.94	\$ 16,632.82	\$1,165.90			\$164,657.65
Material		2,242.16					2,242.15
Subcontract		62,351.00					62,351.00
Travel		4,193.94	297.76				4,491.70
Consultants		1,071.76					1,071.76
Other Direct Costs		770.10	8.34	9.00			787.44
Subtotal		\$343,691.11	\$ 34,959.31	\$4,613.70			\$385,264.12
G&A		10,001.41	5,233.41	815.47			16,050.29
Total Costs Incurred		\$353,692.52	\$ 40,192.72	\$7,429.17			\$401,314.41
Amount in Excess of Contract Amount							(1,314.41)
(l) Total Cost Claimed							\$400,000.00
(m) Fixed Fee							36,000.00
(n) Total							\$436,000.00
(o) Less Previous Payments							(433,871.23)
Amount Due					(p)		\$ 2,128.77

## **iRapt, ICE, and PBR**

### **Submission of Vouchers (Invoices)**

Contractors must submit the completion voucher within 120 days after settlement of the final indirect cost rates covering the year in which the contract is physically complete. However, prior to submitting the completion voucher, DCAA must have completed an audit of the contractor's incurred costs relating to the contract.

Within 6 months after the end of the fiscal year the contractor shall submit a proposed final incurred cost proposal for the period. It should be based on the actual costs during that period and submitted with supporting cost data specifying the contracts and subcontracts to which the rates apply. After the incurred cost proposal is submitted, the contractor's costs will be audited. Normally, a contract cannot be closed out unless the applicable costs have been audited.

## **iRapt, ICE, and PBR**

### **Incurred Cost Electronically (ICE)**

The Allowable Cost And Payment clause (FAR 52.216-7) requires that the contractor submit an adequate final incurred cost proposal together with supporting data, within 6 months after the end of its fiscal year. The receipt of a proposal by the audit office starts the audit process. If the proposal is inadequate the auditor will notify the contractor of the deficiency

The audit will include an evaluation of both direct and indirect costs. The audit objective is to examine contractor cost representations to determine whether such costs are: reasonable, allocable to the contract, in accordance with GAAP and Cost Accounting Standards (CAS), and not prohibited by the contract, Government statute, or regulation.

## **iRapt, ICE, and PBR**

### **Provisional Billing Rates (PBR)**

One criterion for an adequate accounting system is that it provides for billings that can be reconciled to the cost accounts for both current & cumulative amounts claimed, and it comply with contract terms. PBRs are established to approximate the contractor's final rates adjusted for any unallowable costs. PBRs are used for interim purposes until settlement is reached on the final IC rates for the fiscal year.



## **Best Practices to PASS any DCAA Audit / Test**

<b>Knowledge is King</b>	<b>GAAP Principles</b>
Reconciliations and data integrity	Financial statements
Prepaid & accruals	Accounting system compliance
Month end close functions	Audit schedules and third party validations
DCAA Policies & Procedures	Uncompensated Overtime





# QUESTIONS

