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

IN REPLY REFER TO

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10-PSP-021(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA
HEADS OF PRINCIPAL STAFF ELEMENTS, HQ, DCAA

SUBJECT: Audit Alert Related to Budgetary Data Supporting Forward Pricing Rates

SUMMARY

This audit alert is being issued to clarify guidance on the expectations regarding the contractors' use and extent of budgetary data in support of forward pricing rates. Contractors must indicate how they computed and applied their indirect rates while also showing trends and budgetary data with explanations to support the reasonableness of the rates per the requirements of FAR Part 15. The extent of detail will vary depending on the specific data supporting each Fiscal Year and based on the size and complexity of the contractor. When auditing proposed indirect rates, auditors should perform substantive procedures to evaluate the reasonableness of the contractor's basis of estimate (e.g., budgetary data and historical costs/trends). When historical contractor data is used to support the basis of estimate, the auditor must document the substantive audit procedures performed (previously or currently) to ensure the historical data is in reasonable compliance with FAR Part 31.

GUIDANCE

The overarching principal of FAR Part 15, *Contracting by Negotiations*, is that the contracting officer must purchase supplies and services at fair and reasonable prices. Often, indirect rates are a significant portion of the proposed amounts and therefore require audit evaluation of the contractor's basis of estimates (e.g., budgetary data and historical costs/trends) to support the reasonableness of the rates. Contractors are generally required to follow the Table 15-2 instructions for submitting proposals as contained within FAR 15.408. Subsection II, Paragraph C of Table 15-2 provides instructions to the contractor that they must indicate how they computed and applied indirect rates while also showing trends and budgetary data with appropriate explanations to support the reasonableness of the proposed rates. Specifically, Subsection II, Paragraph C, *Indirect Costs*, instructs the contractor to:

> Indicate how you have computed and applied your indirect costs, including cost breakdowns. Show trends and budgetary data to provide a basis for evaluating the reasonableness of proposed rates. Indicate the rates used and provide an appropriate explanation.

Therefore, in accordance with FAR Part 15, a contractor's indirect rates should be based on a well-supported basis of estimate for each Fiscal Year of the proposed period of contract performance. To demonstrate reasonableness, contractors must show how they computed and applied the indirect rates while also providing supporting trend and budgetary data with appropriate explanations commensurate with the size and complexity of the contractor's organization. The contractor's proposal should be prepared in accordance with the contract cost principles and procedures in FAR Part 31 and, when applicable, the requirements and procedures in 48 CFR Chapter 99, *Cost Accounting Standards* (see requirements of FAR 15.404-1(c)(2)(iv)).

At larger contractors it would be expected that the proposed indirect rates for the first year be based on a detailed management-approved operating budget, and each subsequent period be based on adjustments to the operating budget based on strategic or long-range forecasts (e.g., plant expansions, expected business volume, etc.). At a large contractor, with a board of directors, one would expect detailed budgets and forecasts to be in place to provide the directors with knowledge of future planned capital expenditures and other strategic and long range objectives. The contractor's proposed rates should be consistent with this budgetary data. Generally, the level of forecasted detail will decrease as the period being estimated moves further into the future and the uncertainty of conditions and potential events grows. Therefore, it is not expected that even larger contractors prepare detailed operating budgets for each Fiscal Year of contract performance; however, a detailed budget is expected to support the first year of proposed rates. The FAR requires an explanation of how the rates were derived for each of the out-years to allow the contracting officer to ascertain the reasonableness of the rates. For example, flat-lining out-year rates with no explanation to support that the rates will not change in future periods is not adequate. Adjustments to out-year pools and bases should be made based on reasonable sales forecasts and the contractor's assumptions for changes to major groupings of costs (e.g., variable, semi-variable, and fixed). In addition, for multi-segment contractor organizations the budgets and forecasts should reconcile for all significant cost allocations and interdivisional effort supporting the proposed rates. Auditors should consider the guidance at CAM 5-507 and 5-508 which provides information on the types of budgetary documentation that the auditor should expect to be provided by larger contractors in support of their indirect pool and base forecasts used to develop its indirect rates.

As noted above, the auditor must recognize that adequate supporting data and the extent of budgetary data supporting indirect rates will vary from contractor to contractor. Often, smaller contractors do not develop detailed budgets due to their impracticality to their organization. It is not uncommon for smaller firms to have limited budgetary data and assert that historical costs are the most appropriate basis to estimate all out year rates. In these cases, the contractor should provide the necessary trend data with appropriate explanations to support that the historical costs are the most reasonable estimate for the out year rates.

As demonstrated above, the extent of data supporting a contractor's proposed indirect rates will vary by contractor. Therefore, the auditor must exercise judgment in ascertaining if the data provided adequately supports the contractor's proposed rates. The auditor must consider the specific contractor and pending award when opining on whether the proposed rates provide an acceptable basis for negotiation of a fair and reasonable price. To support the opinion rendered, auditors should evaluate the basis and rationale of the contractor's assertion and at a minimum verify historical amounts back to the contractor's books and records and forecasted amounts to other contractor data (e.g., sales forecasts, budgets) while also performing any additional substantive procedures deemed necessary based on any known risk factors. As the risk increases (e.g., the examination of rates applied to Fixed Priced and T&M proposals) auditors should perform increased testing of the assertion to provide reasonable assurance that the contractor's proposal is in compliance with FAR Part 31. This includes procedures related to both the expense pool costs as well as the base costs. The rationale and extent of procedures performed, including the conclusions reached should be appropriately documented in the working paper files.

As outlined in CAM 9-205(d), if the contractor's indirect rate forecasts are not adequately supported throughout the entire period of performance and are so deficient that an examination of the unsupported years cannot be performed, the auditor should recommend that the contracting officer return the proposal to the contractor.

CLOSING REMARKS

FAO personnel should direct questions regarding this memorandum to their regional offices, and regional personnel should direct any questions to Pricing and Special Projects Division, at (703) 767-3290 or e-mail at DCAA-PSP@dcaa.mil.

/Signed/
Kenneth J. Saccoccia
Assistant Director
Policy and Plans

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