DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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PPD 730.5.35.1

September 6, 2012
12-PPD-023(R)

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

SUBJECT: Audit Guidance on Revised Policy and Procedures for Sampling Low-Risk Incurred
Cost Proposals

SUMMARY

To ensure that our limited audit resources are applied to the areas and audits of highest
risk, the policy for evaluating and reporting on low-risk annual incurred cost proposals is being
revised (Enclosure 1). For the purposes of satisfying the audit requirements at FAR 4.804-
5(a)(12), 42.705-1(b)(2), and 42.705-2(b)(2)(i), Defense Procurement and Acquisition Policy
(DPAP) authorized a Class Deviation – DCAA Policy and Procedure for Sampling Low-Risk
Incurred Cost Proposals, dated July 24, 2012, (Enclosure 2). This deviation allows the
Department of Defense contracting officers to continue to rely on either a DCAA audit report or a
DCAA memorandum to satisfy the audit requirements in FAR. The revised policy and its
implementation have been coordinated with Defense Contract Management Agency (DCMA).

POLICY

For in-process assignments where detailed audit steps have been started, auditors should
complete the assignment as it was planned. For all other assignments, the auditor should follow
the revised policy for sampling adequate low-risk incurred cost proposals described in
Enclosure 1. In summary, all adequate incurred cost proposals under $250 million auditable
dollar value (ADV) will be assessed for high or low risk using the Risk Assessment Checklist
(Enclosure 3). All high-risk proposals will be audited and low-risk proposals will be sampled
using the percentages identified in Enclosure 1. Under the revised policy, DCAA will no longer
perform desk reviews. Those proposals not selected for audit will be dispositioned by a
memorandum to the contracting officer (Enclosure 4). In addition, a mandatory audit of
proposals will be performed every three years on proposals between $100 million and $250
million ADV.

The criteria for assessing the risk of a proposal includes prior incurred cost audit
experience, any audit leads or other significant risk identified, as well as the significance of prior
questioned costs. Auditors must use their professional judgment when determining that a
specific proposal can be placed in the low-risk pool for sampling. Auditors must consider their
knowledge of the contractor, the results of adequacy reviews, and other audit activity performed
since completion of the last incurred cost audit (e.g., reported business system deficiencies,
establishment of provisional billing rates, voucher processing procedures, real-time testing of
direct costs, forward pricing audits, etc.) to determine if there are any risks that would warrant

the contractor to be classified as high risk and an audit be performed, especially when significant time has elapsed since the performance of the last incurred cost audit.

Corporate, shared services and Intermediate Home Office (IHO) proposals will not be included in the low-risk sampling process. Corporate/IHO/shared services and segments should coordinate during the adequacy review and risk assessment process to determine if a corporate or home office audit is needed. Coordination efforts should be documented and maintained in the working papers at both Corporate/IHO and segments.

As with the previous desk review process, the revised incurred cost sampling policy does not apply to nonprofit organizations and educational institutions. The revised policy also will not apply to 100% non-DoD contractors at this time. Non-DoD agencies are interested in this process but are waiting to see the guidance before deciding whether to adopt the sampling process. We expect that it will be several months before the non-DoD agencies reach a decision on whether to rely on this sampling process.

Auditors are reminded that the primary objective of the initiative is to redirect audit effort to completion of high-risk and sampled incurred cost audits, beginning with the earlier year proposals first (i.e., oldest to newest). Therefore, to ensure the new policy does not adversely impact on-going audit effort, FAOs should coordinate with the contracting officer and time phase the issuance of the memorandums for proposals not selected for audit. To facilitate the implementation of the revised policy, we have included an implementation plan developed with the assistance of the Regions (Enclosure 5).

Once high-risk and sampled audits have been identified, FAOs should develop a plan to prioritize completion of the audits to support the Agency's goal of being current by the end of FY 2016.

Policy is in the process of updating CAM Chapters 6 and 10 to reflect the revised guidance. In addition, the low-risk sampling policy and procedures have been updated since issuance of the DPAP class deviation to remove the plan to not apply sampling to low-risk proposals $1M or less received prior to October 1, 2011 (Enclosure 1).

SAMPLING GUIDANCE

FAOs should perform risk determinations on all adequate final indirect rate proposals up to $250 million in ADV, focusing on the oldest proposals. DMIS Version 5.3 released in June 2012 allows FAOs to enter a risk code of high or low and a risk reason code for incurred cost proposals up to the $250 million threshold.

Operations will provide each region and Field Detachment (FD) with lists of incurred cost assignments (activity code 10100) where the FAOs have received adequate proposals and determined them to be low risk. The lists may include assignments with ADV of $15M or less

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coded as high risk with a reason of "mandatory third year audit," since the mandatory third year audit will now only apply to contractor proposals exceeding $100 million.

The lists will not include assignments identified as corporate or home office submissions (corporate audit status code = C). The lists will identify proposals coded as direct costs only (Inc Cost Contractor Type = D) to facilitate coordination between FD offices and the cognizant office. Assignments for direct costs should not be included in the sample universes.

The assignments on the lists provided to the regions will be coded in the sample universe field (i.e., LR4Q12) to indicate they have been included in a universe. The regions must review the lists and notify HQ-OWD of any assignments that should not be part of the universe. The assignment should be removed from the universe if, for example, the audit is already in process and detailed audit steps have been started; the submission is for a corporate or home office but not coded as such in DMIS; or all the contracts are non-DoD. HQ-OWD will clear the sample universe field for those assignments in DMIS. Although these assignments will be removed from the current universe, they will appear again in the next universe unless the in-process audit is completed, or the corporate audit status field is revised.

Regions should select a region-wide audit sample using EZ-Quant random number generator and apply the appropriate sampling rate for each universe strata described in Enclosure 1. The number of sample items should be rounded up. For example, if the universe consists of 169 incurred cost proposals with ADV of $1 to $15 million (5% sample rate), resulting in a sample of 8.45 items, the region should randomly select nine proposals for audit using EZ Quant to generate random numbers. The regions must return the lists to HQ-OWD annotating the "Sample Code" column with "X" for do not include in sample universe or "Y" for selected for audit. Using this data, Operations will either clear the sample universe field or enter the data identifying whether the proposal was selected for audit or not. Regions should document their sample selection process and file the documentation in Livelink under a folder named "720.9.2.7 – Incurred Cost Low-Risk Sample Selection" with subfolders for each sample.

Once the region completes the review of the sample universes and selects the samples, it should notify the FAOs to time phase (Enclosure 5) the closure of the low-risk proposals not selected using the procedures in Enclosure 1.

Operations is currently working on an application, similar to the Overdue Incurred Cost Submission Letter Tool, which can be used to generate draft memorandums. We anticipate that this application will be available by September 30, 2012.

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CONCLUDING REMARKS

      Headquarters hosted a teleconference with the Incurred Cost RAMs on August 14, 2012 to address implementation of this guidance. Headquarters is planning to have a teleconference with all of the impacted FAO managers prior to the end of September to address questions and assess progress on implementation. In addition, please see the Frequently Asked Questions for additional information (Enclosure 6).

      FAOs with questions regarding this memorandum should contact their regional offices. Regional personnel should direct any questions regarding the sampling process to Workload Analysis Division at (703) 767-2257, or by e-mail at dcaa-owd@dcaa.mil. Regional personnel with any questions regarding the policy should contact Policy Programs Division at (703) 767-2270 or via e-mail at dcaa-ppd@dcaa.mil.

                    /Signed/
                    John C. Shire
                    Deputy Assistant Director
                    Policy and Plans

Enclosures: 6
  1. Policy and Procedures for Low-Risk Sampling
  2. DPAP Class Deviation
  3. Risk Assessment Checklist
  4. Memorandum to the ACO
  5. Incurred Cost Sampling Implementation Plan
  6. Frequently Asked Questions

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