DCAA Contract Audit Manual (CAM)
(DCCAM 7640.1)

Chapter 6
Incurred Cost Audit Procedures

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6-001 Scope of Chapter **

This chapter provides general audit objectives and foundational guidance applicable to incurred cost audits. Incurred cost audit objectives and guidance applicable to Institutions of Higher Education, Nonprofit organizations, and Federally Funded Research and Development Centers (FFRDCs) are addressed in Chapter 13.

6-100 Introduction to Incurred Cost Audit Objectives **

6-101 Introduction **

a. This section provides general guidance on the audit objectives and approach for incurred costs, including general considerations applicable to all types of contracts and cost categories.

b. FAR 42.503-1 states that a single agency shall be responsible for establishing final indirect cost rates for each business unit. In addition, FAR 42.503-1, 10 U.S.C. 3841(e), and 41 U.S.C. 4706(e) specify that contracting officers should determine whether a previously conducted audit of indirect costs meets the current audit objectives for indirect costs on executed contracts, subcontracts, or modifications. If data can be obtained from an existing source, Federal Agencies are not to conduct duplicative audits of indirect costs.

c. FAR 42.505 provides the requirements for establishing final indirect rates based on contracting officer determination procedures (FAR 42.505-1) or auditor determination procedures (FAR 42.505-2). For purposes of satisfying the FAR 42.505-1(b)(2) and FAR 42.505-2(b)(2)(i) audit requirements for incurred cost proposals, Defense Pricing, Contracting, and Acquisition Policy authorized a Class Deviation – DCAA Policy and Procedures for Sampling Low-Risk Incurred Cost Proposals, dated July 24, 2012. This deviation instructs contracting officers to rely on either a DCAA audit report (attestation examination engagement) or a DCAA memorandum (advisory service) to satisfy the requirements of FAR 42.505.

6-102 Audit Objectives and Approach for Incurred Costs **

6-102.1 Audit Objectives **

The auditor's primary objective is to examine contractor cost representations, in whatever form they may be presented (such as progress payments, incurred cost proposals, and termination claims), and to express an opinion as to whether such incurred costs are:

- Allowable, reasonable, and allocable to the contract under FAR 31;
- Consistent with Generally Accepted Accounting Principles (GAAP) and Cost Accounting Standards (CAS) applicable in the circumstances; and
- Not prohibited by the contract, by statute or regulation, or by previous agreement with, or decision of, the contracting officer.

The discovery of fraud or other unlawful activity is not the primary audit objective; however, audit work should be designed to provide reasonable assurance of detecting abuse or illegal acts that could significantly affect the audit objective. If illegal activity is suspected, the circumstances should be referred to investigative authorities.

6-102.2 Audit Approach **

a. Incurred cost audits are usually performed on a contractor-wide basis. This approach recognizes the efficiency of first gaining an understanding of the adequacy of management and financial systems and controls combined with transaction testing across all business activities as opposed to testing costs applicable to all contracts.

b. Periodic audits of relevant business systems serve to develop an appropriate understanding of systems and controls necessary to determine the nature and extent of transaction testing needed on individual incurred cost audits.

c. For smaller contractors, separate audits of individual contractor business systems may not be necessary. An understanding of the contractor's relevant internal controls may be gained at the time of the final indirect cost audit or during other contract audits. The auditor's understanding of controls gained from these audits should be documented in the permanent file.

d. Regardless of the audit approach, emphasis will be on determining the overall acceptability of the contractor's claimed costs with respect to:

(1) reasonableness of nature and amount;

(2) allocability and measurement pursuant to contract cost principles, CAS, GAAP, and practices appropriate to the circumstances; and

(3) compliance with applicable contract cost limitations or exclusions, federal financial assistance award terms, and/or applicable cost principles. To ensure application of the appropriate clauses and cost principles, auditors must consider the award and clause applicability dates for the subject contracts or financial assistance (e.g., grants, agreements).

e. Auditing incurred costs at multi-segment contractors where an incurred cost proposal covers more than one contractor location requires that audit responsibilities at each location be clearly defined and coordinated to ensure appropriate audit coverage and reduce the potential for duplication of audit effort.

6-103 Audit Scope - Incurred Costs **

a. The procedures and audit guidance presented in this chapter are applicable to all contract audits. However, the auditor must exercise professional judgment in selecting which procedures and techniques are appropriate in the circumstances. The scope of work necessary is a matter of audit judgment considering the contract auditing and reporting standards in the context of a variety of factors involved in a particular audit.

b. When designing the audit procedures for audits of incurred costs, the auditor should also consider the guidance provided in other chapters.

c. If the contractor has received a significant amount in Federal awards from a non-DoW agency, and the non-DoW agency is unwilling or unable to reimburse DCAA for its portion of DCAA’s incurred cost audit services, this may constitute a limitation on the scope of audit.

d. There are some instances where advisory services would be performed on costs incurred on a contract. Some examples of these services would include preparation of risk-based sampling memorandums and unilateral rate memorandums, establishment of interim billing rates, processing of public vouchers, and providing customer assistance with reconciling final vouchers to settlement records. These services are covered in the Advisory Service Guidebook.

6-104 Scope – Risk-Based Sampling of Incurred Cost Proposals **

DoW Class Deviation 2012-O0013 dated July 24, 2012 provides for sampling of low-risk incurred cost proposals. DCAA's policy on risk-based sampling governs the selection of incurred cost proposals (ICPs) for audit, with eligible proposals assessed based on their Sampling Auditable Dollar Volume (ADV) and various risk factors. For ICPs not randomly selected for audit, DCAA will issue a risk-based sampling memorandum and a rate agreement letter, signed by both DCAA and the contractor, to finalize the indirect rates proposed in the ICP.

6-104.1 – Determining Sampling Eligibility **

Unless an exception applies, ICPs with the following Sampling ADV are eligible for sampling:

a. Less than $100 million are eligible for sampling.

b. $100 million to $250 million must be audited every 5th year, or whenever the last **four** incurred costs years were closed with a risk-based sampling memo.

c. Greater than $250 million to $500 million must be audited every 4th year, or whenever the last **three** incurred costs years were closed with a risk-based sampling memo.

d. Greater than $500 million to less than $1 billion must be audited every other year, or whenever the last incurred cost year was closed with a risk-based sampling memo.

e. $1 billion or greater are **not eligible** for sampling and will be audited each year.

6-105 Materiality in Incurred Cost Audits **

a. Materiality refers to misstatements or omissions, whether individually or combined, that could reasonably influence the decisions of intended users. It involves both qualitative and quantitative factors, and their significance in each engagement is determined by the auditor's professional judgment.

b. Auditors must design and perform procedures on all material balances to support their audit opinion, regardless of the assessed risk. However, risk assessment influences the nature, timing, and extent of these procedures. Additionally, qualitative risks may justify auditing amounts below the quantitative materiality threshold.

c. The audit team should identify material cost elements and accounts based on both qualitative and quantitative factors to support the audit opinion. Qualitative or other risk factors used to identify significant items must be supported by objective evidence, such as a history of questioned costs or documented concerns from the contracting officer. If no objective factors exist, the auditor should document quantitative materiality thresholds and any justification for deviating from these thresholds. The process for establishing qualitative and quantitative materiality in Incurred Cost Audits is contained within the Materiality Guidebook.

6-106 Audit Objectives for Major Cost Elements **

Incurred cost audits encompass several major cost areas and cost elements, and include assessing and evaluating whether costs charged to Government contracts are necessary, comply with contract terms, and are allowable, allocable and reasonable and consistent with FAR 31 Contract Cost Principles and Procedures, GAAP, and CAS. Additional audit objectives, for example, may include verification that:

(1) Labor Costs are supported by proper timekeeping, payroll, and personnel records, and internal controls over labor charging and allocation are adequate.

(2) Materials were received, used, and accounted for in accordance with contract terms and internal controls over purchasing, receiving, inventory, and material issuance are adequate.

(3) Indirect cost methods and bases used to allocate indirect costs are acceptable, indirect cost rate calculations and the application of those rates are accurate and consistent, and internal controls over indirect cost charging and allocation are adequate.

(4) Other Direct Costs are supported by adequate documentation and internal controls over purchasing and cost charging are adequate.

(5) Subcontract Costs are supported by appropriate documentation and comply with subcontract terms, internal controls over subcontract award, administration, and monitoring are adequate, and the Government is not paying excessive pass-through costs if the contracting officer determines the contractor does not provide "added value" to subcontracted work pursuant to FAR 52.215-22, 52.215-23, and 31.203(i).

Additional information on the considerations and potential approaches to auditing each cost element is contained within the Incurred Cost Audits Guidebook, Incurred Subcontract & Inter-Organizational Guidebook, and Selected Areas of Cost Guidebook.

6-107 Penalties on Expressly Unallowable Costs **

Federal statutes and regulations impose penalties on contractors who include expressly unallowable costs in their final indirect cost rate proposals or claims for reimbursement under Government contracts. Expressly unallowable costs are those specifically identified as unallowable by law, regulation, or contract. These provisions ensure that only allowable costs are reimbursed under Government contracts and that contractors are held accountable for compliance with cost principles and regulations.

a. Penalty provisions are established under 10 U.S.C. 3743 and 41 U.S.C. 4303, and implemented in FAR 42.508.

b. By definition, a cost is expressly unallowable if the applicable cost principle states in direct terms that the cost is unallowable, leaving little room for interpretation.

c. Contractors are responsible for affirmatively identifying and excluding expressly unallowable costs from their proposals and claims. Failure to do so may result in penalties.

d. The Administrative Contracting Officer (ACO) determines whether a penalty should be assessed and issues a demand letter for the amount. The auditor is responsible for communicating all unallowable costs potentially subject to penalties to the ACO, regardless of materiality. The auditor has no authority to recommend or impose the penalty, recover it against subsequent public vouchers, or waive the penalty. This authority rests with the ACO.

e. Penalties may include both a base penalty and an additional penalty if the contractor knew or should have known the costs were unallowable.

f. Penalty provisions apply to costs included in final indirect cost rate proposals and do not flow down to subcontracts.

g. Contractors are required to certify their proposals do not include expressly unallowable

costs. If a contractor uses statistical sampling, projected amounts of unallowable costs are also subject to penalty.

6-108 Approaches to Establish Indirect Costs **

Indirect cost rates are used to reimburse contractors for indirect costs under cost-type contracts and to determine billable amounts on progress payments under certain fixed-price contracts. The following methods ensure these indirect cost rates are established in a manner consistent with contract terms, applicable regulations, and sound accounting practices:

a. Audit Determination: Final indirect cost rates may be set based on the results of an audit or accepted as proposed if a low-risk sampling process is used. The auditor's determination is generally final, but contractors have the right to appeal. Procedures for this method are described in FAR 42.505-2 and DFARS 242.505-2.

b. Contracting Officer Determination: Final rates can be negotiated between the ACO and contractor, based on the contractor's proposal and audit report or advisory memorandum. Procedures for this method are described in FAR 42.505-1 and DFARS 242.505-1.

c. Special Procedures: In some cases, the process for settling a contractor's indirect cost rates may shift from being determined by negotiation with a contracting officer to being determined by audit, especially when both parties agree that rates can be settled easily or when special circumstances apply.

d. Educational Institutions, State and Local Governments, and Nonprofit Organizations: Procedures for establishing indirect cost rates for contracts at these organizations are discussed in FAR 42.505-3 through 42.505-5, respectively.