



DEFENSE CONTRACT AUDIT AGENCY
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IN REPLY REFER TO

PAC 730.3.B.01/2013-02

August 7, 2014
14-PAC-013(R)

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

SUBJECT: Audit Guidance on Reporting a CAS Noncompliance in an Incurred Cost Audit and a Forward Pricing Audit

As a result of the FAO Assistant for Quality training on incurred cost audits, several questions arose about the difference between reporting a CAS noncompliance in a forward pricing audit versus an incurred cost audit. The following guidance addresses those questions and clarifies actions and rationales for both types of audits.

Forward Pricing

Actions Required When a CAS Noncompliance is Identified during the Audit

When an auditor identifies a potential CAS noncompliance during a forward pricing audit, the auditor must determine if the potential noncompliance is significant. Once significance is determined, the audit team should establish a 19200 assignment to report the noncompliance and follow the guidance in CAM 8-302.7.f. The auditor then should question the impact of the noncompliance in the proposal under audit and reference the 19200 report that was issued or will soon be issued.

When the auditor is unable to obtain sufficient evidence from the contractor to determine either the significance of the CAS noncompliance or the impact on the proposal under audit, the auditor then will have a reservation about the engagement. The auditor should issue a report with a modified opinion according to the guidance in CAM 2-402.3.

Actions Required When an Outstanding CAS Noncompliance Impacts the Audit

When there is an outstanding CAS noncompliance that impacts a forward pricing audit, the auditor should follow the guidance in CAM 8-302.7.f, question the impact of the noncompliance in the proposal under audit, and reference the 19200 report that was issued. If the auditor is unable to obtain sufficient evidence from the contractor to determine the impact on the proposal under audit, the auditor then will have a reservation about the engagement and should therefore issue a report with a modified opinion according to the guidance in CAM 2-402.3

Why Do We Question the Impact in the Forward Pricing Report?

We question the impact in the forward pricing report to protect the Government's interest.

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How to protect the Government's interest:

1. **Ensuring a timely adjustment to price in CAS-covered contracts.** If the award of a CAS-covered contract includes a noncompliant practice, FAR 30.605 governs an adjustment in contract price. However, there is risk that the Government might not resolve the cost impact in a timely manner and recovery by the Government could be limited.
2. **Ensuring an adjustment to price in non-CAS-covered contracts.** Even if the contract is not CAS covered, it may be impacted by a needed adjustment in cost allocation resulting from the CAS noncompliance. By questioning the impact of the noncompliance, the Government is able to negotiate an award value that incorporates the impact of the noncompliance or provide for a reasoning to include a reopener clause. For firm-fixed-priced, non-CAS-covered contracts, these two actions represent the best opportunities for the Government to recover the impact of the noncompliance. This is important because the Truth in Negotiations Act (TINA) doesn't allow for future price adjustments if the Contracting Office had knowledge of the noncompliance prior to agreement on the price of a contract that requires submission of certified cost or pricing data.

Incurred Cost

Actions Required When a CAS Noncompliance is Identified during the Audit

When an auditor identifies a CAS noncompliance during an incurred cost audit, the auditor must determine if the noncompliance is significant. Once the significance is determined, the audit team should establish a 19200 assignment to report the noncompliance. For the identified CAS noncompliance, the auditor should **not compute** the impact of the noncompliance in the audit report. The notes to the report should include:

- the nature of the CAS noncompliance;
- information relating to the status of the 19200 audit report (which includes an estimate of the impact of the noncompliance); and
- comments that the resolution of the CAS noncompliance will be handled through the resolution process specified in FAR 30.605.

Since there is no requirement to question the impact of the CAS noncompliance in the audit report, the auditor will not have a reservation about the engagement for the lack of quantifying the impact in the exhibits and schedules of the report.

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Actions Required When an Outstanding CAS Noncompliance Impacts the Audit

When there is an outstanding CAS noncompliance that impacts the incurred cost audit, the auditor should report the noncompliance, but **do not compute** the impact of the noncompliance in the audit report. The notes to the report should include:

- the nature of the CAS noncompliance;
- information relating to the status of the 19200 audit report (which includes an estimate of the impact of the noncompliance); and
- comments that the resolution of the CAS noncompliance will be handled through the resolution process specified in FAR 30.605.

Since there is no requirement to question the impact of the CAS noncompliance in the audit report, the auditor will not have a reservation about the engagement for the lack of quantifying the impact in the exhibits and schedules of the report.

Why Do We Not Question the Impact in the Incurred Cost Report?

We do not question the impact in the incurred cost report because FAR 30.605 provides a specific process that the Government must follow to resolve a reported CAS noncompliance before making any contract price or cost adjustment to affected CAS-covered contracts. The process requires the Cognizant Federal Agency Official (CFAO), after receiving a report of a CAS noncompliance, to determine if the practice is compliant or noncompliant. If the CFAO determines the practice is noncompliant, then the contractor is required to submit a cost accounting practice change to correct the noncompliance. Once the CFAO determines the proposed change to correct the noncompliance is adequate and compliant, the CFAO will request a general dollar magnitude (GDM) proposal. The GDM will calculate the cost impact of the noncompliant practice on **all affected** CAS-covered contracts and subcontracts. If the cost impact results in material increased costs to the Government **in the aggregate**, then the CFAO will recoup the increase costs through contract adjustments or an alternate method.

The following are reasons why questioning the costs in the audit report does not satisfy the resolution process:

1. **Incurred cost may not include all affected CAS-Covered Contracts.** In most cases, not all affected CAS-covered contracts are included in the incurred cost proposal. This is because only the cost type contracts are part of the contractor's incurred cost proposal, not fixed-price contracts. If the noncompliance impacts fixed-priced CAS-covered contracts, consideration of this type of contract is necessary to determine increased cost in the aggregate.

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2. **Incurred cost may not cover all years of the noncompliance.** A noncompliant practice can span multiple years, whereas the contractor's incurred cost proposal is limited to one year. If the noncompliance spans multiple years, consideration of all the affected CAS-covered contracts and the entire amount associated with the noncompliant practice over the years is necessary to determine increased costs in the aggregate. In addition, some of the years' final indirect cost rates might be established; therefore, the resolution process would be the only method to recoup the increased costs.
3. **Auditor's recommended compliant practice may not be the contractor's proposed practice to correct the noncompliance.** Under CAS, the contractor may have several different options to establish a complaint practice. For example, CAS 418 provides general guidance that the contractor must use to establish a compliant allocation method for its cost. While the auditor may use a practice to develop the potential cost impact, it may or may not be the practice the contractor establishes to correct the noncompliance. Therefore, the final cost impact amount could vary significantly from the auditor's potential cost impact calculation.

Questions and Further Information

We have included some frequently asked questions as an enclosure to this MRD. FAO personnel should direct questions regarding this memorandum to their regional offices, and regional personnel should direct any questions to Accounting and Cost Principles Division at (703) 767-3250 or e-mail at DCAA-PAC@dcaa.mil.

/s/ Debra M. Caw
/for/ Donald J. McKenzie
Assistant Director
Policy and Plans

Enclosure:
Frequently Asked Questions

DISTRIBUTION: E

FREQUENTLY ASKED QUESTIONS

Question 1: How do we handle a situation where we have audit-determined final indirect rates and did not identify any questioned costs but have identified a CAS noncompliance?

Answer: FAR 30.605 states that the CFAO is responsible for resolving a CAS noncompliance. DCAA does not have the authority to resolve the CAS noncompliance as part of its incurred cost audit. Therefore, the auditor should issue a report with a modified opinion according to the guidance in CAM 2-402.3. The auditor should not issue a final rate agreement letter.

Question 2: If the CAS noncompliance identified would result in an increased price on the proposal under audit, should the auditor adjust the proposal for the increased costs?

Answer: Since the reason for adjusting the proposed price for the noncompliance is that there is a concern the Government may not be able to recover the impact of the noncompliance, the auditor should not adjust the proposal if the result of the noncompliance is a higher price on the proposed contract. If the Government includes this higher amount and the noncompliance is later determined to be immaterial, or if the Government is unable to recover that increased price, the Government would be harmed by the increased amount included in the contract price. In addition, if this contract is a CAS-covered contract and the noncompliant process was included in the negotiated price, it would be an affected contract subject to adjustment at a later date using the process specified in FAR 30.605.

Question 3: When doing a cost impact audit for a CAS noncompliance, does an auditor have to determine if the contract was adjusted for the noncompliance?

Answer: FAR 30.605(h) states that when computing the cost impact, the impact shall include all affected CAS-covered contracts and subcontracts. FAR 30.001 defines an affected contract as a contract that used a noncompliant practice for purposes of estimating or accumulating and reporting costs under the contract or subcontract. If the contract was adjusted for the noncompliant practice, it would not be considered an affected contract. Therefore, the auditor should ensure that contracts already adjusted for the noncompliance are not included in the contractor's cost impact.

Question 4: The reasons that we do not quantify the impact of the CAS noncompliance on incurred costs are (1) there is a process specified in FAR 30.605 for resolving CAS issues, (2) the incurred cost does not include all affected contracts, (3) the incurred cost may not cover all years of the noncompliance, and (4) the auditor's determination of the compliant practice may not be the final approved compliant practice. Why is the policy on forward pricing different than for incurred cost, since most of these same issues exist on a forward pricing proposal?

Answer: The incurred cost includes previously negotiated CAS-covered contracts that meet the definition of an affected contract. As an affected contract, the adjustment to these contracts for the CAS noncompliance would have to go through the process specified in FAR 30.605. Since a proposal is not a contract, making an adjustment for the noncompliance before award would

relieve it from being an affected contract. If it is not an affected contract, it is not subject to the adjustment requirements specified in FAR 30.605. This provides the Government with the flexibility of how to handle the adjustment for the proposed contract, either adjust the price as part of the negotiation, or adjust the price as part of the CAS resolution process specified in FAR 30.605. As indicated in the MRD, DCAA is recommending that the Contracting Officer adjust for the noncompliance as part of the negotiation process to protect the Government.

Question 5: The MRD indicates that if an auditor identifies a potential noncompliance during an incurred cost audit, the auditor must determine if the potential noncompliance is significant. Does this mean the auditor should compute a general dollar magnitude (GDM) or detailed cost impact (DCI) as part of the incurred cost or proposal audit?

Answer: It is the responsibility of the contractor to compute a GDM or DCI, as specified in FAR 30.605. The auditor has only to document in their working papers that they have determined the noncompliance is significant. As specified in CAM 8-302.7, the following items make a CAS noncompliance significant:

- violations of major requirements of CAS;
- the auditor considers the impact significant;
- the auditor determined the noncompliance is not currently significant but the noncompliance could become significant if the situation changes; and/or
- the noncompliance is an inherent part of the contractor's accounting system.

The level of documentation required would be dependent on which criteria the auditor used to determine that the noncompliance is significant and reportable. In determining if the impact of the noncompliance is significant, the auditor should not compute a GDM or DCI but should have adequate documentation in the working papers to support the conclusion that the impact is significant "in the aggregate" during the period of the noncompliance. In most cases, a rough order of magnitude analysis would meet this requirement.

Question 6: When citing a CAS 405 noncompliance in an incurred cost audit, do I impact the costs for the unallowable costs?

Answer: This Standard does not govern the allowability of costs. CAS 405 fundamentally requires costs that are expressly unallowable or mutually agreed to be unallowable, be identified and excluded from any billing, claim, or proposal applicable to a Government contract. If the contractor has a practice or process that consistently allowed for a claim or billing of expressly unallowable costs or costs that are mutually-agreed to be unallowable on all CAS-covered fixed-price contracts and prior year CAS-covered flexibly-priced contracts, a CAS 405 noncompliance can be issued to potentially recover those costs. In the case of CAS 405, the underlying FAR Part 31 noncompliance still must be reported in the incurred cost audit report, whether or not the prior year costs are recovered does not impact the allowability of the costs being reported.