

NAME CHANGE FROM NONAUDIT SERVICES TO ADVISORY SERVICES

The guidance in this MRD is still current guidance with the exception of the use of the word nonaudit services. When the guidance is incorporated into CAM or is obsolete, the guidance will be closed or cancelled as appropriate.

Historically, DCAA has referred to services other than audits as nonaudit services; however, the types of services DCAA has performed as nonaudit services do not meet the definition of nonaudit services as defined by the Generally Accepted Auditing Standards (GAGAS). To avoid confusion to those outside of DCAA, we have renamed nonaudit services to **advisory services**.

This change is one in name only, and does not affect the procedures currently defined for each activity code. Memorandums issued upon completion of these advisory services will continue to contain the statement that the scope of the work performed does not constitute an audit or attestation engagement under GAGAS. Policy is in the process of updating all references to nonaudit services within the guidance to advisory services.



DEFENSE CONTRACT AUDIT AGENCY

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IN REPLY REFER TO:

PSP 730.5.01.A\2015-008

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16-PSP-005(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
ASSISTANT DIRECTORS, HQ, DCAA

SUBJECT: Audit Alert on DCMA Implementation Guidance on Blended Compensation Caps

This guidance is effective immediately.

The Bipartisan Budget Act of 2013 (BBA) (see MRD 14-PPD-004(R), dated April 7, 2014) implemented a compensation limitation of \$487,000 applied to all contractor employees for new contracts subject to FAR 31.2 awarded on or after June 24, 2014; as a result, contractors may be subject to multiple compensation limits each year beginning in 2014. Director, Defense Pricing (DDP) and the Defense Contract Management Agency (DCMA) issued guidance allowing contractors to address these multiple limits (caps) using a "blended rate" approach.

DDP Memorandum, "Use of Blended Rates to Implement Multiple Compensation Caps" (October 25, 2014).

Based on the subject memo, DDP allows contractors to use a blended compensation cap if they consider this approach to be beneficial. Blended caps will be calculated by each individual contractor as a weighted average composite cap specific to their contract volume prior to, and on or after June 24, 2014. The objective is to simplify compliance while continuing to protect the interests of the Government. If the contractor proposes to use a blended cap, the contractor and Administrative Contracting Officers (ACO) are required to execute an advance agreement. The advance agreement should outline the agreed-to process, auditable data submission, and applicable period for the blended rates. The DDP memo (Enclosure 1) specifies DCAA will complete an audit to ensure that only the total allowable compensation is billed to the Government for the fiscal year based on the different authorized caps.

SUBJECT: Audit Alert on DCMA Implementation Guidance on Blended Compensation Caps

DCMA Implementation “Guidance on the Use of Blended Rates to Implement Multiple Compensation Caps” (January 29, 2016)

DCMA guidance to its ACOs provides a background of the multiple compensation caps, discusses blending methodologies and requirements for final overhead, interim billing, and forward pricing rates. The guidance provides 17 questions and answers that discuss relevant contractual considerations and detailed examples of blending calculations for incurred cost and forward pricing.

The DCMA guidance also establishes the overall framework for effectively implementing the blending approach in a manner that is equitable and protects the Government. The ACOs must execute an advance agreement when a contractor chooses to use a blended compensation cap. DCMA will request DCAA assistance with the proposed advance agreement and request DCAA evaluation of the contractor’s forward pricing and incurred cost proposals to ensure the contractor’s proposed use of blended compensation caps does not result in the Government pricing or paying compensation costs in excess of the total allowable compensation amounts. DCMA requires the ACO to address DCAA blended compensation cap audit findings in its Pre-Negotiation Objective Memorandum or Memorandum for Record. The ACO must follow the process in DCMA-INST 126 “Contract Audit Follow Up” (for incurred cost) and DCMA-INST 130 “Forward Pricing Rates” (for forward pricing) to resolve and/or disposition the audit report. The DCMA guidance (Enclosure 2) provides a template for the advance agreement.

DCAA Responsibility

Initially, DCAA will provide a non-audit service on the proposed advance agreement to ensure that it complies with the DDP guidance. DCAA should identify any processes that could result in the inclusion of compensation costs exceeding the allowable cap, and to confirm the terms to ensure that the contractor will maintain auditable data necessary to support the performance of our audit responsibilities. DCAA will communicate information related to the advance agreement to the contracting officer in a memorandum signed by the FAO Manager (see FAQ #2 for what information to include in the memorandum). Audit teams should charge DMIS Activity Code 23600 for the non-audit service and must maintain documentation of the non-audit service relating to the understanding between the team and DCMA; nature and scope of work performed; and a copy of the memorandum provided to DCMA.

SUBJECT: Audit Alert on DCMA Implementation Guidance on Blended Compensation Caps

After the ACO has executed an advance agreement, DCAA will audit forward pricing proposals, interim billing rates, and incurred cost submissions to ensure that compensation costs do not exceed the total amount allowable. DCAA's primary audit responsibility is to determine contractor compliance with applicable compensation limits when the contractor has decided to implement blended compensation caps and to provide audit findings to the ACO. Audit teams should question any amount of compensation costs priced or billed in excess of the legal compensation limits. Enclosure 3 provides frequently asked questions related to key areas of consideration and expected actions for each engagement.

Questions and Further Information



FAO personnel should direct questions regarding this memorandum to their regional offices, and regional personnel should direct questions to Ms. Suzanne Windes, Acting Chief, Pricing and Special Projects Division at (520) 794-5206 or e-mail at DCAA-PSP@dcaa.mil or Mr. Joseph Bucsko, Chief, Policy Programs Division at (703) 767-3290 or e-mail at DCAA-PPD@dcaa.mil.

/Signed/

Donald J. McKenzie
Assistant Director
Policy and Plans

Enclosures: 3

1. Director, Defense Pricing Memorandum
2. DCMA Implementation Guidance
3. Frequently Asked Questions

Enclosure 1	Enclosure 2
 DDP Memo.pdf	 DCMA Blended Rate Guidance.pdf

DISTRIBUTION: E

Frequently Asked Questions

Advance Agreement Questions

1. What factors should the audit team consider when providing the non-audit service on the proposed advance agreement?

Response: The advance agreement should spell out the significant processes and calculations as well as the data the contractor will maintain to support its calculations and auditable data needed for DCAA's audit. Accordingly, audit teams should consider the following factors:

- **Basis for Measuring the Volume of Contract Effort** – The audit team should confirm what the contractor is proposing to use as a basis of measuring the volume of contract effort (e.g., labor cost by year/contract, sales by year/contract)?
 - Confirm the proposed basis to determine if the relevant amounts are objective and verifiable for both a historical and forward looking basis.
 - Confirm the proposed basis to determine the total value is consistent with data used to establish the applicable rates. If the contractor proposed basis for calculating the total contract volume is higher than the base used to calculate the actual rates, auditors should obtain an explanation for the difference and discuss with the contracting officer.
 - Confirm the proposed basis for measuring contract volume can be identified by actual or anticipated contract award date and also facilitates exclusion of contracts that are not subject to FAR part 31.2.
 - Confirm the contractor is able to demonstrate that their basis for measuring contract volume is representative of actual compensation. For example, if a contractor has one contract that represents 20 percent of the proposed compensation that is subject to the cap, the proposed basis for measuring contract volume (e.g. total cost input) should also reflect 20 percent for the same contract.

If the auditor confirms the contractor's proposed method of blending is not consistent with how they report costs in normal incurred cost and forward pricing proposals, the audit team needs to inform the ACO that the proposed blending method will not allow DCAA to perform our audit responsibilities in protecting the Department from excessive compensation.

- **Accuracy of Calculations** – Confirm that the contractor's proposal includes a demonstration that the actual costs priced or billed to the government do not exceed that allowed by law. This requires the identification of the total compensation costs, the pools or base amounts from which the costs in excess of the identified caps will be removed from. The auditor should confirm the data included in the calculations are auditable and verifiable.
- **Method for Accumulation of Compensation Costs** – Confirm that the contractor has identified the total compensation. The level of detail will vary depending on the type of rates and the time period involved. The contractor may provide a detailed identification of compensation incurred for employees in the incurred cost submission and an estimate (based on escalating historical actuals) for the current assignment. When assisting with the advance agreement, use historical submissions to identify and understand how compensation costs are accounted for and how the costs in excess are identified.

2. What information should I provide in the Memorandum to the ACO after performing the non-audit service on the proposed advance agreement?

Response: The audit team needs to provide the ACO with information related to whether the advance agreement will allow DCAA to perform our audit responsibilities in protecting the Department from excessive compensation.

- If there were **no significant concerns**, the audit team should state in the memorandum that “The proposed advance agreement will allow DCAA to perform our audit responsibilities in protecting the Department from excessive compensation.”
- If there were **significant concerns**, the audit team should state in the memorandum that “The proposed advance agreement will not allow DCAA to perform our audit responsibilities in protecting the Department from excessive compensation.” The audit team should provide some detail to the ACO of where the proposed advance agreement falls short **BUT** the audit team needs to ensure that the information provided would not be considered fixing the contractor’s proposal as this can create a potential independence impairment. Some acceptable examples of information that can be shared is:
 - The proposed advance agreement does not ensure the maintaining of auditable supporting data
 - The proposed advance agreement does not contain the expiration of the application of blended rates
 - The proposed advance agreement’s agreed-to process does not ensure protection of the Department from excessive compensation

The memorandum must also contain the statement that “The scope of the work performed does not constitute an audit or attestation engagement under generally accepted government auditing standards.”

3. What do we mean when we say “priced” or “billed”?

Response: The distinction between the two is important, as each carries a unique risk to the government and may require different audit procedures. A cost is priced to the government when it is included in a contractor’s forward looking estimate and included in the total cost and resulting price of a Government Contract. In terms of the compensation caps, the forward looking estimate used to price the impact of the compensation caps, generally, will be the contractors forward pricing rate proposal. On flexible contracts, the amount actually incurred may differ from the initial estimate – these changes impact the amount being reimbursed but, absent a change in the scope of work, generally do not change the estimated fee or profit that was priced into the contract.

A cost is billed to the government through interim or final billing. The term “billing” is applicable to the amount the contractor is requesting the Government pay on flexibly-priced contracts. The amount of costs billed to the government is calculated based on the direct costs incurred and application of interim or final indirect rates. The impact of the blended compensation cap may be reflected in direct labor costs or as part of the interim billing or final indirect cost rates. DCAA audits these costs as part of the incurred cost audit process.

Forward Pricing Questions

4. What should I do if I receive a contractor forward pricing rate proposal that used a blending approach without an advance agreement?

Response: The audit team should immediately contact the ACO to discuss the need and expectation for obtaining an advance agreement along with any extenuating circumstances for accepting a proposal without an advance agreement. You should stress the importance of the advance agreement and its design to ensure that the proposed process calculates costs in excess of established limits, that the contractor uses a consistent approach over time, and that the appropriate data required to support DCAA mandatory audits is identified and/or maintained. However, given the potential acquisition time constraints involved, do not immediately stop your analysis upon identification that no advance agreement exists or return the proposal as inadequate. Our audit of the forward pricing rate proposal must ensure that we understand the contractor's blending calculation and should obtain adequate supporting documentation to ensure that we are able to identify any excess compensation **priced** into the proposal. **This is critical because this will be the only opportunity to remove unallowable costs priced into firm-fixed price contracts.** Our audit note must address the totality of the issue and clearly document all findings in the audit report note. If we find any amount of excess cost, provide this finding to the ACO for disposition. Under the DCMA guidance, the ACO must separately disposition these findings and is ultimately responsible to ensure that the Department does not pay excessive compensation caused by a blending approach.

5. What actions are required to address contractor proposals using a blended approach that were negotiated without an advance agreement prior to the DCMA implementing guidance?

Response: Audit teams should work with their ACOs to ensure that the required elements of the advance agreement (i.e., outline agreed-to process; auditable data submission for forward pricing, interim billing, and incurred cost; and expiration for the application of blended rates) are established and the rights of the Department are communicated and agreed to by the ACO and contractor.

6. Can you provide an example of what an explanatory note for blended compensation caps might look like in a forward pricing rate proposal audit?

Response: The explanatory note relating to a blended compensation cap, generally, will be reflected as an explanation to the amount the contractor has proposed to remove. The structure and format of your exhibits will be unique to your submission. The following provides one possible scenario and the resulting explanatory note.

Summary of conclusion:

The proposed disallowance factor was increased to remove compensation costs that exceed the allowable limits established in FAR 31.205-6(p). The contractor did not remove these costs due to the use of an overstated blended compensation cap. We

estimate the overstated compensation cap will result in the inclusion of unallowable costs of \$8.4 million in 2015, \$5.5 million in 2016, and \$3.1 million in 2017 in the XYZ rate. This will result in pricing unallowable costs into U.S. Government Contracts contrary to the limits established in FAR 31.205-6(p).

Basis of Estimate

The proposed disallowance factor is based on discretely estimated unallowable costs for each year. The estimated costs include multiple cost elements including compensation in excess of allowable limits established in FAR 31.205-6(p). XYZ determined multiple FAR 31.205-6(p) limits are applicable to its contracts, and calculated a weighted average cap based on the total cost input (TCI) base incurred on firm work (e.g. contract/business that is known and already awarded-this includes all business both cost type and firm fixed price that is subject to the FAR 31.205-6(p) limits – see column A in the following table), modifications to those contracts (this is an estimated number based on expected changes to contracts awarded prior to 6/24/14– see Column B), and new effort. The weighted average for the pre-BBA cap is the sum of firm work and estimated modifications to those contracts. The weighted average for the BBA cap is composed of all new effort.

	A	B	A+B=C	D	C+D=E	C/E*952=F	D/E*487=G	F+G
	TCI for Contracts Already Priced	Estimated TCI for Modifications to pre 6/24/14 Contracts (New Pricing)	Total TCI For Contracts Awarded Pre 6/24/14	TCI for Estimated Future Effort (New Pricing)	TCI	Weighted Cap on Pre 6/24/14	Weighted Cap on Post 6/24/14	Blended Cap
2015	\$750,000	\$10,000	\$760,000	\$190,000	\$950,000	\$761,846	\$97,400	\$859,246
2016	\$500,000	\$10,000	\$510,000	\$490,000	\$1,000,000	\$485,677	\$238,630	\$724,307
2017	\$300,000	\$10,000	\$310,000	\$740,000	\$1,050,000	\$281,158	\$343,219	\$624,377

Audit Evaluation:

We examined the contractor's proposed disallowance factor to determine the basis of estimate and to establish compliance with procurement regulations. We compared the sum of all contract volume used in the calculation to the total cost input proposed by the contractor for calculating the G&A rate and noted no material differences. (***Guidance Note – this step is required to ensure that the contractor is consistent in identifying the volume of business between the calculation of the compensation cap and the total base used to calculate the rates***). We determined the compensation contributing to the unallowable cost was included in the G&A pool, accordingly, use of the TCI base provides a reasonable approximation to the assignment of compensation costs to contracts (***Guidance Note – this step is required to confirm the factor used to calculate business volume is consistent with the allocation of compensation costs – if compensation costs are allocated over direct labor hours – use of a TCI base heavily influenced by direct material may be inappropriate***). We traced the proposed breakdown of the volume into applicable time periods (e.g., contracts awarded prior to and on or after June 24, 2014) to supporting documentation and noted no significant

differences. However, we determined the contractor's inclusion of firm work resulted in overstating the volume of affected contracts subject to the higher \$952 thousand cap. These contracts have already been priced, with no downward adjustment. As a result, the contractor's proposal includes total compensation that exceeds the allowable limits established by FAR 31.205-6(p).

We removed the firm work from the contractor's proposal and recalculated the weighted average compensation cap on new pricing only as shown below. Using the revised cap, we identified compensation in excess of this cap and included this increased, unallowable cost in the calculation of the disallowance factor.

	A	B	A+B=C	A/C*952=D	B/C*487=E	D+E
	Estimated TCI for Modifications to pre 6/24/14 Contracts (New Pricing)	TCI for Estimated Future Effort (New Pricing)	TCI	Weighted Cap on Pre 6/24/14	Weighted Cap on Post 6/24/14	Blended Cap
2015	\$10,000	\$190,000	\$200,000	\$47,615	\$462,650	\$510,265
2016	\$10,000	\$490,000	\$500,000	\$19,046	\$477,260	\$496,306
2017	\$10,000	\$740,000	\$750,000	\$12,697	\$480,507	\$493,204

Incurred Cost Questions

7. What should I do if I receive or if I have already received a contractor incurred cost proposal that used a blending approach without an advance agreement?

Response: The DCMA guidance reinforced Departmental Policy of the need to execute an advance agreement to protect the Department before blending compensation caps. DCAA's incurred cost audit is the only way to ensure that total compensation **billed** does not exceed the amount allowable. Given the importance of understanding the contractor's proposed blending method and the need to maintain auditable supporting data, the audit team should do the following:

- **For incurred cost proposals the audit team has already received** before the DCMA guidance was finalized, audit teams should immediately notify the ACO of the need for an advance agreement and designate "P" in the DMIS proposal status field and must enter "blended" and "the date of notification to DCMA" (e.g. Blended March 14, 2016) in the Agency Wildcard Field 1. This will allow us to identify at an Agency level and provide information to DCMA where negotiations of advance agreements are required for existing contractor proposals. DCMA will negotiate advance agreements by June 30, 2016. If DCMA is not able to enter into the advance agreement with the contractor within that time period, the audit team should update the DMIS proposal status field from a "P" to an "R" and return the proposal to the contractor and require the contractor to resubmit the proposal after executing an advance agreement with the ACO.
- **For any new proposals received before June 1, 2016** that do not have an advance agreement, audit teams should follow the same process described in the preceding bullet.
- **For any new incurred cost proposals received on or after June 1, 2016**, the audit team should immediately notify the ACO that the incurred cost proposal is being returned to the contractor because of the lack of an advance agreement necessary to ensure DCAA

can perform our audit responsibilities to protect the Department. The audit team will also return the incurred cost proposal to the contractor and require the contractor to resubmit the proposal only after executing an advance agreement with the ACO. When returning proposals, audit teams should designate “R” in the DMIS proposal status field and must enter “blended” in the Agency Wildcard Field 1. This will allow us to identify at an Agency level and provide information to DCMA where negotiations of advance agreements are necessary to protect the Department.

8. Can you provide an example of what an explanatory note for blended compensation caps might look like in an incurred cost audit?

Response: The explanatory note relating to a blended compensation cap, generally, will be reflected as an explanation to the amount the contractor has proposed to remove. The structure and format of your exhibits will be unique to your submission. The following provides one possible scenario and the resulting explanatory note.

XYZ Company 20xx Incurred Cost Submission

Contractor Proposed	Engineering OH	Manufacturing Overhead	Company Wide Fringe	General and Administrative	Explanatory Note
Total Incurred Costs	\$ 494,187	\$ 261,897	\$ 913,852	\$ 791,468	
Costs Removed					
Costs in Excess of Compensation Cap	11,872	5,861	21,104	18,412	2
Misc. Other Unallowable	<u>5,000</u>	<u>1,000</u>	<u>4,000</u>	<u>6,000</u>	
Proposed Net Allowable Costs	<u>\$ 477,315</u>	<u>\$ 255,036</u>	<u>\$ 888,748</u>	<u>\$ 767,056</u>	
DCAA Questioned Costs					
Costs in Excess of Compensation Cap	\$ 1,000	\$ 250	\$ 2,481	\$ 2,000	
Audit Established Net Allowable	<u>\$ 476,315</u>	<u>\$ 254,786</u>	<u>\$ 886,267</u>	<u>\$ 765,056</u>	2

Explanatory Notes

2. Costs in Excess of Compensation Cap

a. Summary of Conclusion. The contractor calculated costs in excess of compensation cap are understated and not compliant with the requirements of FAR 31.205-6(p). The contractor did not remove these costs due to the use of an overstated blended compensation cap. We estimate the overstated compensation cap will result in the inclusion of unallowable costs as shown in the Exhibit. This will result in pricing unallowable costs into U.S. Government Contracts contrary to the limits established in FAR 31.205-6(p). ***(Guidance note – contracts are affected by multiple different caps as summarized in FAR 31.205-6(p). This is the criteria that should be referred to in the explanatory notes rather than the statute or action that initially established the cap. Throughout this guidance we do refer to the BBA Cap as a means to distinguish the significant change and the potential impact, however DCAA Audit Reports should refer to FAR 31.205-6(p) as the basis for disallowance.)***

b. Basis of Estimate. XYZ determined 10 percent of the contracts incurring costs in 20xx were subject to the compensation caps in place after June 24, 2014 and 90 percent of the contracts were subject to the caps in place prior to that date. Compensation costs are included in multiple different pools; accordingly, the contractor concluded that use of separate FAR 31.206(p) caps for each group of contracts would be difficult. Therefore, XYZ calculated a weighted average cap as shown on page xx of the contractor's submission (for this example, refer to question 7 in the DCMA blended cap implementation guidance). The contractor then identified total compensation for each of its employees. Total compensation included salary, health insurance and retirement costs. The contractor did not include employee performance bonus payments in its calculation of total compensation. The total compensation was then compared to the weighted average cap, and costs in excess of that cap were identified as costs in excess to be removed. XYZ removed the costs from the pool to which they were initially booked.

c. Audit Evaluation: We first evaluated the contractor's calculation of the weighted average compensation cap. We determined that the contractor was using total cost input as the base used to break out contract amounts subject to the different compensation caps. We verified the total cost input allocations were consistent with the overall allocation of compensation costs and take no exception to the use of this basis. We traced the contracts included in the various groupings to actual contract terms to confirm the appropriate assignment to various caps (e.g., pre-6/24/14 and after 6/24/14) and noted no significant differences. ***(Guidance Note – while in the forward pricing example, the contractor may use high level percentages and estimates to identify the weighting of the various caps, it is important during the incurred cost audit to tie these amounts to the actual contract terms and actual measurement of volume incurred during the given year. DCMA guidance provides background information on different contract types and the application of the appropriate limitation in questions 11, 12, 13, and 14. This is a major difference between the incurred cost audit that is based on actual contract volume and contract terms and the interim billing and forward pricing engagements that are based on estimates. We must confirm during the non-audit service on the advance agreement that we have the visibility necessary to identify the contracts included and to identify the actual volume incurred in order to complete this step.)*** We verified the amounts reflected in the weighting calculation to the amounts shown in the costs incurred by contract in the incurred cost submission and noted differences. We evaluated these differences and determined that the weighting calculation did not reflect actual year end amounts – we obtained an updated calculation that reflected a revision to the compensation cap. We noted no other exceptions to the calculation of the cap.

We then evaluated the contractor's identification of total compensation to verify that all costs subject to the limitations per the FAR definition are considered in the calculation of costs in excess of the cap. We determined that the contractor's failure to consider performance bonus was not consistent with the FAR definitions. Inclusion of this amount results in increasing the costs in excess of the FAR 31.205-6 limitation.

Using the accurate identification of total compensation and the updated weighted average cap, we calculated the required exclusion and reflect this as questioned cost.