

Recommendation 11: Develop a Professional Practice Guide for DoD's oversight of contractor costs and business systems.

Problem

DoD's oversight functions within DCAA provide professional services and skilled advice to contracting officers. The quality and consistency of this advice is highly dependent on the quality and consistency of foundational standards that guide the professionals' work.

Background

Although professional standards are common in the accounting and auditing profession, none have been collaboratively developed or interpreted for the unique purpose of federal government contract oversight. DCAA's *Contract Audit Manual* provides a good foundation, but it lacks the collaborative inputs, perspectives, and interpretations of knowledgeable professionals outside DCAA and the government. This point is important because IPAs and other qualified professional services firms are playing an increasingly important role in the government's oversight of federal government contractors.

Findings

Professional standards represent principles rather than rules and are thus subject to interpretation. DoD's oversight professionals will benefit from a uniform, collaborative interpretation of applicable professional standards. Without a Professional Practice Guide, contracting officers will be underserved and likely confused by inevitable inconsistencies among audit and advisory reports issued by DCAA, DCMA, and IPAs. Professional standards of particular importance that require a collaborative interpretation include (among many others) independence, objectivity, materiality, sufficient evidence, and reliance on the work of others.

Conclusions

A Professional Practice Guide will clarify the types of engagements (tools in the toolbox) that may be performed to accomplish DoD's contract compliance oversight objectives. Currently, the government's oversight lexicon consists of the term audit to describe nearly every type of oversight activity (see Recommendation 7b). DoD does not need this level of assurance in connection with every oversight activity. Audits are appropriate in certain circumstances, but other types of advisory engagements (which may include other forms of audit) may be better suited to provide the information contracting officers need, when they need it (given the nature and extent of potential risks). For DoD's internal controls over contractor costs and business systems to be effective and efficient, DoD's oversight professionals must have more tools in their toolboxes.

Performance audits should be used more extensively to meet the contracting officers' need for a high level of assurance. Performance audits provide oversight professionals with more flexibility and the ability to deliver more valuable information without sacrificing the same high level of assurance.

The Professional Practice Guide should set forth clear materiality guidelines that focus oversight professionals on providing the information contracting officers need to make reasonable business decisions. What may be material to a particular business decision will be influenced by a variety of qualitative and quantitative considerations, recognizing that contracting officers' role is to manage

DoD's risk (rather than avoid it). The cost of DoD's oversight, including adverse effects on the timeliness of decision-making, must be balanced with expected benefits of that oversight. The CASB's administrative regulations establish a variety of *qualitative* materiality considerations appropriate for and applicable to any business decision affecting contract costs/prices.¹

For instance, materiality is a well-established concept in the auditing professional standards, and its application is well understood in financial statement audits. How the materiality concept applies to contract audits, however, has not been thoroughly examined and defined. The materiality concept is based on the premise that an amount is material if it would change or influence the view or decision of a reasonable person. With respect to contract audits, contracting officers and their teams use the audited information as the basis for negotiating contract prices and reimbursing contractors' costs. Thus, to address the user's needs in this regard, auditors must consider materiality from both *qualitative* (nature) and *quantitative* (dollar amount) perspectives. The considerations at 48 CFR 9903.305 provide a sound foundation for assessing qualitative aspects of materiality. Establishing quantitative materiality thresholds for audit planning, determining fair and reasonable contract prices, and settling contract cost reimbursements would improve the efficiency and effectiveness of the DoD's oversight function. Quantitative materiality thresholds represent a margin of permissible imperfection in the potential expenditure of tax dollars. Accordingly, the quantitative materiality thresholds must be calibrated to a reasonable users' expectations concerning the nature and amount of unallowable costs that would influence or change their decisions. The Section 809 Panel expects the Professional Practice Group to not only establish quantitative thresholds for various contract audit, contract award, and cost settlement situations, but also provide guidance and examples on how to apply these thresholds in these specific situations consistent with the following examples. For individual contract pricing actions, the procuring contracting officer is primarily concerned about the affect unallowable costs may have on contract price. Contract type and the degree of competition are also significant considerations bearing on cost/price risk.

Example 1a: Competition is the largest influence in contract price determination. Cost allowability is an ongoing requirement for payment during contract performance on cost-type contracts. Thus, any unallowable costs that may have been included in the initial contract price can be identified and removed at any time prior to contract close-out. Higher preaward materiality thresholds do not adversely affect the Government's ability to manage cost risk. An appropriate quantitative materiality threshold could be 10 percent of the total proposed contract price.

Example 1b: Negotiation of non-competitive fixed prices represents the highest degree of cost risk for contracting officers. Unlike cost type contracts, the Government generally cannot detect and remove unallowable costs after contract award. This circumstance suggests a progressively lower materiality level is appropriate as contract value increases as envisioned below:

¹ Materiality, 48 CFR 9903.305.

Up to \$100k	Up to \$500k	Up to \$1m	Up to \$5m	Up to \$10m	Up to \$50m	Up to \$100m	Up to \$500m	Over \$500m
5%	5%	5%	3%	2.5%	2%	1.5%	1%	0.5%
			Step-down	Step-down	Step-down	Step-down	Step-down	
			0.5% per \$1m	0.1% per \$1m	0.1% per \$10m	0.1% per \$10m	0.1% per \$100m	

Certain contract requirements affect the cost/price of more than one contract. These matters are often managed by administrative contracting officers, who are concerned with the total aggregate impact on contract costs/prices as well as those of individual contracts.

Example 2: Potential materiality thresholds for annual final indirect cost rate settlements will reflect the effect on total reimbursable contract costs for the contractor’s fiscal year. The thresholds should provide a useful point of reference to guide audit planning and the nature of final indirect cost rate settlements. A formulaic approach to determine a contractor’s annual aggregate materiality level is compatible with, and supportive of, the Government’s materiality thresholds for contract quick-closeouts (see FAR 42.708). The formulaic approach below replicates the quantitative materiality thresholds for ranges of reimbursable incurred costs proposed in the House version of the FY 2018 NDAA.

ADV								
Up to \$100k	Up to \$500k	Up to \$1m	Up to \$5m	Up to \$10m	Up to \$50m	Up to \$100m	Up to \$500m	Over \$500m
Materiality Threshold = \$5,000 x ((Total ADV/\$100,000)^.75)								
\$5,000	Up to \$16,719	Up to \$28,117	Up to \$94,015	Up to \$158,114	Up to \$528,686	Up to \$889,140	Up to \$2,973,018	Up to See formula

In addition to each of the examples, the Section 809 Panel recognizes and endorses that a different and significantly lower planning materiality would be used for expressly unallowable costs and sensitive audit areas.

Implementation

Legislative Branch

- No statutory changes are required.

Executive Branch

- In accordance with the statutory requirements of DoD and the Section 809 Panel, set forth in Section 803 of the FY 2018 NDAA, the Section 809 Panel will establish a team (to include at a minimum GAO, DCAA, AICPA, and industry) to develop a Professional Practice Guide, which includes materiality standards, for contract auditing to be completed prior to the sunset of the Section 809 Panel in January 2019.

- Require GAO to maintain the Professional Practice Guide, according to best practices.

Implications for Other Agencies

- There are no cross-agency implications for this recommendation.