

Recommendation 15: Clarify and streamline the definition of and requirements for an adequate *incurred cost proposal* to refocus the purpose of DoD's oversight.

Problem

The term *incurred cost proposal* is not defined within federal acquisition regulations, the effect of which has been to create unnecessary burdens on both the Government and contractors.¹ Incurred cost proposal is the government contracting community's shorthand way of referring to a contractor's *final indirect cost rate proposal*. An annual final indirect cost rate proposal, the elements of which are defined in FAR 52.216-7(d), is necessary for the contractor and the government to establish final indirect cost rates for purposes of settling provisionally billed (i.e., estimated) indirect costs on flexibly priced contracts. The government's responsibilities for negotiating or establishing final indirect cost rates is set forth in FAR 42.705.

Although the final indirect cost rate proposal necessarily includes details regarding all contract costs (indirect and direct), direct costs are included because (a) the government needs to verify the completeness and accuracy of the contractor's total costs to avoid double-counting and (b) direct costs are the most common means by which contractors allocate indirect costs to contracts. A final indirect cost rate proposal is not a claim for direct costs incurred and billed during contract performance. FAR 42.702 indicates that an audit of the final indirect cost rate proposal is performed for the sole purpose of negotiating final indirect cost rates.²

In recent years, DCAA began auditing direct costs, as well as indirect costs, during its *incurred cost audits*. Before then, DCAA's audit procedures concerning direct costs were limited to verifying their completeness such that final indirect cost rates are calculated accurately. In general, expanding the scope of incurred costs audits may increase the time it takes DCAA to complete incurred cost audits and increase the time it takes contracting officers to address and resolve the results of DCAA's audits.

Background

The government added new requirements of an *adequate* final indirect cost rate proposal to FAR 52.216-7(d)(2)(iii) in 2011.³ These newly required elements of a final indirect cost rate proposal were directly based on DCAA's incurred cost electronic model, which DCAA created many years ago to help contractors prepare their final indirect cost rate proposals in a consistent manner and provide appropriate cost detail to make DCAA's audit oversight more efficient. Many of the required elements of an adequate final indirect cost rate proposal have no bearing on calculating, understanding, auditing, and negotiating final indirect cost rates. This collection of unnecessary data has contributed to DCAA losing its focus on the purpose and scope of contractors' final indirect cost rate proposal and has created unnecessary work for contractors, DCAA, and especially contracting officers.

¹ Definitions of Word and Terms, FAR Part 2. Contract Administration and Audit Services, FAR Part 42.

² Indirect Cost Rates: Purpose, FAR 42.702.

³ "Federal Acquisition Regulation; Contract Closeout," Federal Register, accessed November, 2017, <https://www.federalregister.gov/documents/2011/05/31/2011-12852/federal-acquisition-regulation-contract-closeout>.

Findings

The timeliness of final rate settlements and consequent contract closeouts will substantially improve if DCAA refocuses its oversight on the purpose of the final indirect cost rate proposal to reasonably ensure the allowability of contractors' actual indirect costs, not direct costs. The term incurred cost proposal is not defined anywhere in the FAR, it must be made clear it is the same as—not different from—a final indirect cost rate proposal. This small change will help DCAA and contracting officers refocus on the purpose of FAR 52.216-7(d) and FAR 42.705.

Conclusions

Reviewing and settling contractor final indirect cost rates as a reform measure may raise concern among some stakeholders about DCAA's oversight of contractor direct costs. The allowability of contractor direct costs is also an important compliance requirement. It is not, however, the purpose of DCAA's evaluation of contractor final indirect cost rate proposal. Rather, a contracting officer may request DCAA to audit the direct costs of a contract pursuant to FAR 52.216-7(g), which is an entirely different oversight request than a final indirect cost rate proposal audit.⁴ If DCAA performs adequate voucher reviews, which has always been one of DCAA's important responsibilities, there should be no cause for concern.

DCAA must refocus on its mission of providing contracting officers with the information they need to do their jobs as prescribed in contracts and by the FAR. DCAA should not be auditing direct contract costs unless requested to do so by the contracting officer as set forth in FAR 52.216-7(g).

Several final indirect cost rate proposal schedules that have no bearing on evaluating or settling final indirect cost rates should be removed. These schedules are currently *required*; they should be made *optional* information that may be required, if necessary, during the audit process. This relatively minor adjustment will meaningfully reduce contractors' burden to prepare its final indirect cost rate proposal and help DCAA stay focused on the purpose of contractors' proposals and contracting officers' responsibility to settle indirect cost rates.

Implementation

Legislative Branch

- No statutory changes are required.

Executive Branch

- Define *incurred cost proposal* in FAR 52.216-7 as being synonymous with a final indirect cost rate proposal, and make some elements (I-M and O) of the indirect cost rate proposal in FAR 52.216-7(d)(2)(iii) optional.

⁴ Allowable Cost and Payment: Audit, FAR 52.216-7(g), states: "At any time or times before final payment, the Contracting Officer may have the Contractor's invoices or vouchers and statements of cost audited. Any payment may be: (1) reduced by amounts found by the Contracting Officer not to constitute allowable costs; or (2) Adjusted for prior overpayments or underpayments."

Implications for Other Agencies

- Because the FAR pertains to agencies across the federal government, any changes to the FAR would affect other agencies in that they would be expected to implement the changes, as would DoD.

- Define *incurred cost proposal* in FAR 52.216-7 as being synonymous with a final indirect cost rate proposal, and make some elements (I-M and O) of the indirect cost rate proposal in FAR 52.216-7(d)(2)(iii) optional.

Modify standard clause FAR 52.216-7 as follows:

(d) Final indirect cost rates.

(1) Final annual indirect cost rates and the appropriate bases shall be established in accordance with Subpart 42.7 of the Federal Acquisition Regulation (FAR) in effect for the period covered by the indirect cost rate proposal.

(2)

(i) The Contractor shall submit an adequate final indirect cost rate proposal (i.e., an “incurred cost proposal”) to the Contracting Officer (or cognizant Federal agency official) and auditor within the 6-month period following the expiration of each of its fiscal years. Reasonable extensions, for exceptional circumstances only, may be requested in writing by the Contractor and granted in writing by the Contracting Officer. The Contractor shall support its proposal with adequate supporting data.

(ii) The proposed rates shall be based on the Contractor’s actual cost experience for that period. The appropriate Government representative and the Contractor shall establish the final indirect cost rates as promptly as practical after receipt of the Contractor’s proposal.

(iii) An adequate indirect cost rate proposal shall include the following data unless otherwise specified by the cognizant Federal agency official:

(A) Summary of all claimed indirect expense rates, including pool, base, and calculated indirect rate.

(B) *General and Administrative expenses (final indirect cost pool)*. Schedule of claimed expenses by element of cost as identified in accounting records (Chart of Accounts).

(C) *Overhead expenses (and/or other final indirect cost pool)*. Schedule of claimed expenses by element of cost as identified in accounting records (Chart of Accounts) for each final indirect cost pool.

(D) *Occupancy expenses (and/or other intermediate indirect cost pool)*. Schedule of claimed expenses by element of cost as identified in

accounting records (Chart of Accounts) and expense reallocation to final indirect cost pools.

(E) Claimed allocation bases, by element of cost, used to distribute indirect costs.

(F) Facilities capital cost of money factors computation.

(G) Reconciliation of books of account (*i.e.*, General Ledger) and claimed direct costs by major cost element.

(H) Schedule of direct costs by contract and subcontract and indirect expense applied at claimed rates, as well as a subsidiary schedule of Government participation percentages in each of the allocation base amounts.

~~(I) Schedule of cumulative direct and indirect costs claimed and billed by contract and subcontract.~~

~~(J) *Subcontract information.* Listing of subcontracts awarded to companies for which the contractor is the prime or upper tier contractor (include prime and subcontract numbers; subcontract value and award type; amount claimed during the fiscal year; and the subcontractor name, address, and point of contact information).~~

~~(K) Summary of each time and materials and labor hour contract information, including labor categories, labor rates, hours, and amounts; direct materials; other direct costs; and, indirect expense applied at claimed rates.~~

~~(L) Reconciliation of total payroll per IRS form 941 to total labor costs distribution.~~

~~(M) Listing of decisions/agreements/approvals and description of accounting/organizational changes.~~

~~(H)(N)~~ Certificate of final indirect costs (see 52.242-4, Certification of Final Indirect Costs).

~~(O) Contract closing information for contracts physically completed in this fiscal year (include contract number, period of performance, contract ceiling amounts, contract fee computations, level of effort, and indicate if the contract is ready to close).~~

(iv) The following supplemental information is not required to determine if a proposal is adequate, but may be required during the evaluation of proposed final indirect costs rates or other cost evaluations applicable under this clause. audit process:

(A) Comparative analysis of indirect expense pools detailed by account to prior fiscal year and budgetary data.

(B) General organizational information and limitation on allowability of compensation for certain contractor personnel. See 31.205-6(p). Additional salary reference information is available at http://www.whitehouse.gov/omb/procurement_index_exec_comp/.

(C) Identification of prime contracts under which the contractor performs as a subcontractor.

(D) Description of accounting system (excludes contractors required to submit a CAS Disclosure Statement or contractors where the description of the accounting system has not changed from the previous year's submission).

(E) Procedures for identifying and excluding unallowable costs from the costs claimed and billed (excludes contractors where the procedures have not changes from the previous year's submission).

(F) Schedule of cumulative direct and indirect costs claimed and billed by contract and subcontract.

(G) *Subcontract information.* Listing of subcontracts awarded to companies for which the contractor is the prime or upper-tier contractor (include prime and subcontract numbers; subcontract value and award type; amount claimed during the fiscal year; and the subcontractor name, address, and point of contact information).

(H) Summary of each time-and-materials and labor-hour contract information, including labor categories, labor rates, hours, and amounts; direct materials; other direct costs; and, indirect expense applied at claimed rates.

(I) Reconciliation of total payroll per IRS form 941 to total labor costs distribution.

(J) Listing of decisions/agreements/approvals and description of accounting/organizational changes.

(K) Contract closing information for contracts physically completed in this fiscal year (include contract number, period of performance, contract ceiling amounts, contract fee computations, level of effort, and indicate if the contract is ready to close).

(L)~~(F)~~ Certified financial statements and other financial data (e.g., trial balance, compilation, review, etc).

(M)~~(G)~~ Management letter from outside CPAs concerning any internal control weaknesses.

(N)~~(H)~~ Actions that have been and/or will be implemented to correct the weaknesses described in the management letter from subparagraph (G) of this section.

(O)~~(I)~~ List of all internal audit reports issued since the last disclosure of internal audit reports to the Government.

(P)~~(J)~~ Annual internal audit plan of scheduled audits to be performed in the fiscal year when the final indirect cost rate submission is made.

(Q)~~(K)~~ Federal and State income tax returns.

(R)~~(L)~~ Securities and Exchange Commission 10-K annual report.

(S)~~(M)~~ Minutes from board of directors meetings.

(T)~~(N)~~ Listing of delay claims and termination claims submitted which contain costs relating to the subject fiscal year.

(U)~~(O)~~ Contract briefings, which generally include a synopsis of all pertinent contract provisions, such as: Contract type, contract amount, product or service(s) to be provided, contract performance period, rate ceilings, advance approval requirements, pre-contract cost allowability limitations, and billing limitations.

(v) The Contractor shall update the billings on all contracts to reflect the final settled rates and update the schedule of cumulative direct and indirect costs claimed and billed, as required in paragraph (d)(2)(iii)(I) of this sections, within 60 days after settlement of final indirect cost rates.

(3) The Contractor and the appropriate Government representative shall execute a written understanding setting forth the final indirect cost rates. The understanding shall specify

- (i) the agreed-upon final annual indirect cost rates,
- (ii) the bases to which the rates apply,
- (iii) the periods for which the rates apply,
- (iv) any specific indirect cost items treated as direct costs in the settlement, and
- (v) the affected contract and/or subcontract, identifying any with advance agreements or special terms and the applicable rates.

The understanding shall not change any monetary ceiling, contract obligation, or specific cost allowance or disallowance provided for in this contract. The understanding is incorporated into this contract upon execution.

- (4) Failure by the parties to agree on a final annual indirect cost rate shall be a dispute within the meaning of the Disputes clause.
- (5) Within 120 days (or longer period if approved in writing by the Contracting Officer) after settlement of the final annual indirect cost rates for all years of a physically complete contract, Contractor shall submit a completion invoice or voucher to reflect the settled amounts and rates. The completion invoice or voucher shall include settled subcontract amounts and rates. The prime contractor is responsible for settling subcontractor amounts and rates included in the completion invoice or voucher and providing status of subcontractor audits to the contracting officer upon request.
- (6)
 - (i) If the Contractor fails to submit a completion invoice or voucher within the time specified in paragraph (d)(5) of this clause, the Contracting Officer may--
 - (A) Determine the amounts due to the Contractor under the contract; and
 - (B) Record this determination in a unilateral modification to the contract.
 - (ii) This determination constitutes the final decision of the Contracting Officer in accordance with the Disputes clause.