



**DEFENSE CONTRACT AUDIT AGENCY**  
**DEPARTMENT OF DEFENSE**  
8725 JOHN J. KINGMAN ROAD, SUITE 2135  
FORT BELVOIR, VA 22060-6219

IN REPLY REFER TO

PPD 730.5.35.1

October 29, 2013  
13-PPD-021(R)

**MEMORANDUM FOR REGIONAL DIRECTORS, DCAA**  
**DIRECTOR, FIELD DETACHMENT, DCAA**  
**HEADS OF PRINCIPAL STAFF ELEMENTS, HQ, DCAA**

**SUBJECT:** Audit Guidance on Revised Policies and Procedures for Low-Risk Incurred Cost Proposals Less Than \$250 Million in ADV

This memorandum revises the DCAA policies and procedures for sampling low-risk incurred cost proposals previously established in MRD 12-PPD-023(R), dated September 6, 2012.

**What do FAOs have to do?**

FAOs shall assess (or reassess) risk for all adequate proposals with ADV less than \$250 million where fieldwork has not been started using the revised policies and procedures (Enclosure 1) and the appropriate Risk Determination tool (Enclosures 2 and 3). Additionally, FAOs will need to update DMIS to reflect any changes necessary based on these assessments; the Implementation Timetable is enclosed (Enclosure 4).

**What are the new policies and procedures?**

The complete policies and procedures are included as Enclosure 1. The key changes to the policies and procedures include:

1. Changed prior year questioned cost thresholds.

<b>ADV Strata</b>	<b>Policies and Procedures Changes</b>
<\$1M	Questioned cost is $\geq$ 10% of the last completed incurred cost audit's ADV
\$1M-\$5M	Questioned cost is $\geq$ 5% of the last completed incurred cost audit's ADV or \$100K, whichever is greater
\$5M-\$250M	Questioned cost is $>$ \$250K in the last completed incurred cost audit

2. If the last incurred cost audit performed found no significant questioned costs, all proposals with less than \$5 million in ADV **should be considered low-risk unless** significant relevant risk material to the incurred cost proposal exists, such as fraud referral (Form 2000), "unacceptable" opinion from a pre-award accounting review, no previous experience (e.g., voucher processing, forward pricing effort, pre-award accounting systems, etc.), or specific relevant risk with the contractor that has material impact to the incurred cost proposal (identified by the contracting officer or auditor).

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3. For all proposals between \$5 million and \$250 million in ADV, if the last incurred cost audit performed found no significant questioned costs, auditors should use professional judgment to determine risk considering significant relevant risk applicable to the proposal, such as fraud referral (Form 2000), “unacceptable” opinion from a pre-award accounting review or reported business system deficiencies relevant to the incurred cost proposal, (e.g., voucher processing, forward pricing effort, pre-award accounting systems, etc.), or specific relevant risk with the contractor that has material impact to the incurred cost proposal (identified by the contracting officer or auditor).
4. There will be no sampling for low-risk proposals with ADV <\$1M.

### **Why were changes made to the policies and procedures?**

As part of Headquarters on-going monitoring of the low-risk annual incurred cost proposals and feedback we received from regions and field auditors, we determined a need for revisions to our policy.

Policy performed an analysis of audits completed in FY 2013 to determine if our incurred cost sampling process is working in the most efficient manner to apply our limited audit resources to the audit areas with the highest risk. This will ensure our incurred cost sampling process is effective, while still protecting the taxpayer. Based on this analysis, we found that there was room for improvement. Therefore, adjustments were made to the questioned cost thresholds and the sampling percentages.

In addition, feedback from the field indicated that the current risk determination criteria requires revision to better allow auditors to use their professional judgment when determining if an adequate incurred cost proposal is high risk or low risk. Therefore, the risk determination criteria was modified, and the tools were updated to make it less of a checklist and more of a tool to assist the auditor in documenting the judgments they made in arriving at their final determination of high or low risk.

### **Questions and Further Information**

FAOs with questions regarding this memorandum should contact their regional offices. Regions with questions should contact Policy Programs Division at (703) 767-2270 or via e-mail at DCAA-PPD@dcaa.mil.

/Signed/  
Donald J. McKenzie  
Assistant Director  
Policy and Plans

DISTRIBUTION: E

DCAA Policy and Procedures for  
Sampling Low-Risk Incurred Cost Proposals V3

**POLICY**

All incurred cost proposals should be evaluated upon receipt for adequacy, in accordance with FAR 52.216-7, using the DCAA Incurred Cost Proposal Adequacy checklist. If the incurred cost proposal is not adequate and the deficiencies cannot be remedied with minor effort, contact the contractor to discuss the deficiencies and then return the proposal to the contractor with written instructions on required corrective actions, in accordance with CAM Chapter 6.

All adequate annual incurred cost proposals exceeding \$250 million in auditable dollar value (ADV) will be audited. All other incurred cost proposals received and determined to be adequate will be assessed for risk. All adequate high-risk proposals will be audited.

Corporate, shared services and Intermediate Home Office (IHO) proposals will not be included in the low-risk sampling process. Corporate/IHO/shared services and segments should coordinate during the adequacy review and risk assessment process to determine if a corporate or home office audit is needed. For example, if all segment proposals are considered low-risk, the Corporate/IHO/shared services audit is not needed and can be closed with a low-risk memo. Coordination efforts should be documented and maintained in the working papers at both Corporate/IHO and segments.

**CRITERIA FOR CLASSIFICATION OF PROPOSALS TO HIGH-RISK AND LOW-RISK POOLS**

For all proposals with \$250 million or less in ADV, FAOs should classify risk as high or low for all adequate incurred cost proposals on hand where an audit (field work) has not been started, using the criteria specified below.

**Low-Risk Proposal Criteria < \$250M ADV**

1. Significant Questioned Costs in the last completed incurred cost audit
  - a. If the last completed incurred cost audit's ADV is < \$1M, significant questioned cost is  $\geq 10\%$  of that year's ADV
  - b. If the last completed incurred cost audit's ADV is \$1M to \$5M, significant questioned cost is  $\geq 5\%$  of that year's ADV or \$100K, whichever is greater
  - c. If the last completed incurred cost audit's ADV is \$5M to \$250M, significant questioned costs is  $> \$250K$ .

The amount of questioned costs reported in the last completed incurred cost year's audit is calculated by adding the amount of questioned costs from DMIS for that year's audit (which already considers government participation), plus questioned costs applicable to allocated costs from corporate, intermediate home office, etc. multiplied by government participation.

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*Sample Calculations:*

Sample Calculation: Last completed incurred cost year's questioned costs recorded in DMIS (with 60% government participation) for Segment A (a)	\$7,000
Corporate Office's questioned costs allocable to segment A for that year (b)	\$20,000
Shared Services' questioned costs allocable to segment A for that year (c)	\$5,000
Total Corporate Office and Shared Services' questioned costs allocable to Segment A (d = b + c)	\$25,000
Segment A's participation (e)	60%
Total Corporate Office and Shared Services' questioned costs allocable to Segment A with participation consideration (f = d x e)	\$15,000
Total last completed incurred cost audit's questioned costs for Segment A with participation consideration (a + f)	\$22,000

2. Significant Relevant Risk Material to the Incurred Cost Proposal

The audit team must use professional judgment when determining whether there is any significant relevant risk material to the incurred cost proposal. The audit team should consider the issues below when making the determination of high or low risk. Use the Risk Determination Tool to document the relevant specific significant risk(s) that support your determination that an audit is warranted.

- a. For all proposals with less than \$5 million in ADV, the proposal should be considered low risk unless significant relevant risk material to the proposal exists such as:
  - i. Known significant fraud referral (Form 2000) applicable to the proposal fiscal year or the period in which the proposal was prepared
  - ii. Pre-award accounting system performed that resulted in an opinion of "unacceptable," or no previous experience with the contractor such as voucher processing, forward pricing effort, pre-award accounting systems, etc.
  - iii. Specific relevant risk with the contractor that has material impact to the incurred cost proposal being assessed (i.e., significant CO/Auditor identified risk)
  
- b. For all proposals with \$5 million - \$250 million in ADV, consider the following significant risk criteria:
  - i. Known significant fraud referral (Form 2000) applicable to the proposal fiscal year or the period in which the proposal was prepared
  - ii. Pre-award accounting system performed that resulted in an opinion of "unacceptable," or there are reported business system deficiencies relevant to the incurred cost year under audit
  - iii. No previous experience with the contractor such as voucher processing, forward pricing proposal, pre-award accounting system, etc.

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- iv. Specific relevant risk with the contractor that has material impact to the incurred cost proposal being assessed (i.e., significant CO/Auditor identified risk)

**LOW-RISK SAMPLING PERCENTAGES**

Low-risk proposals will be selected for audit using sampling techniques based on the guidance below. An adequacy evaluation must be performed prior to designating a proposal as low risk. No other audit procedures will be applied to the remaining low-risk proposals not selected for audit.

<b>Low-Risk Adequate Proposals by Auditable Dollar Value (ADV)</b>	<b>Low-Risk Sampling Percentages</b>
Less Than \$1Million	0%
\$1Million to \$50 Million	5%
\$50 Million to \$100 Million	10%
\$100 Million to \$250 Million*	20%
Greater than \$250 Million	100%

\* A mandatory incurred cost audit will be performed once every three years for all proposals greater than \$100 million up to \$250 million. If a contractor does not have a proposal selected for audit in the 20 percent sample in a three-year cycle, the FAO shall select a proposal for audit the third year after the last audit. This selection is in addition to those incurred cost proposals selected for audit in the 20 percent sample for any given Government fiscal year.

**CLOSURE METHODS TO BE USED FOR PROPOSAL CONSIDERED LOW-RISK NOT SELECTED FOR AUDIT**

The following procedures will be performed on the proposals in the low-risk pool that were not selected in the sample for audit:

- Issue a Memorandum for Contracting Officer (using the sample Low-Risk ACO Memo). The signed indirect cost rate agreement, subcontractor release statement (if applicable), and a tailored cumulative allowable cost worksheet should be attached to the Low-Risk Memorandum for Contracting Officer. If a cumulative allowable cost worksheet is not available, attach Schedule H and I from the proposal and tailor the memo accordingly.
- Low-risk proposals not selected in the sample for audit should be closed with disposition code “N – Assignment completed but no formal report issued” with the “Low-Risk Memo” option from the disposition type drop-down menu as of the date of the memorandum to the contracting officer. The proposal ADV should be reported in the “Dollars Examined Gross” field on the disposition tab in DMIS to ensure that we maintain visibility of the dollars associated with assignments closed without audit.

## DCAA Policy and Procedures for Sampling Low-Risk Incurred Cost Proposals V3

There has been no change to our procedures for computing proposal ADV. Calculate the dollars examined using the same procedures as if an audit were performed. Proposal ADV excludes allocated costs and subcontractor costs that would normally be audited by another FAO. See page A-15 of the DMIS Users Guide for detailed procedures for calculating ADV. Costs questioned and total exception dollars will be reported as zero. The Audit, Desk Review, or No Audit field entry will be “N = No Audit” and the Audit Determined/Negotiated field entry will be “N = Negotiated.”

### **PROCEDURES**

- Upon receipt of this guidance, the FAO should identify all incurred cost proposals on hand for which the audit has not started.
- Perform an adequacy determination, if not already completed.
- All adequate incurred cost proposals exceeding \$250 million in ADV will be audited.
- Proposals less than or equal to \$250 million received and determined adequate will be assessed for risk. The auditor will determine whether these proposals should be included in the high-risk pool or low-risk pool using the Risk Determination Tool.
- All adequate incurred cost proposals included in the high-risk pool will be audited.
- All adequate low-risk incurred cost proposals less than \$1M ADV will not be subject to random sampling.
- All adequate low-risk incurred cost proposals between \$1M and \$250 M ADV will be randomly selected for audit based on the following sampling percentages. Regional offices in coordination with OWD will determine and document the sampling plan.
  - Five percent (5%) of the incurred cost proposals of \$1 million to \$50 million included in the low-risk pool will be randomly selected for audit.
  - Ten percent (10%) of the incurred cost proposals of \$50 million to \$100 million included in the low-risk pool will be randomly selected for audit.
  - Twenty percent (20%) of the incurred cost proposals of \$100 million to \$250 million included in the low-risk pool will be randomly selected for audit. A mandatory incurred cost audit will be performed once every three years.
- Draft a memorandum to the contracting officer for those low-risk proposals not selected for audit unless the FAO has multiple proposals on hand from the same contractor, then follow the procedures below.
  - If no low-risk proposals for the contractor are selected in the sample for audit, close out all adequate incurred cost proposals that were in the sampling pool for that contractor using the procedures discussed above.
  - If one or more low-risk proposals are selected in the sample for audit, do not disposition any of the subsequent fiscal years for the contractor until the audit is completed. However, you may disposition the low-risk year(s) prior to the year selected for audit.

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- If significant questioned costs as defined above are found, audit all subsequent incurred cost proposals that were in the sampling pool for the contractor using multi-year audit techniques.
  - If no significant questioned costs are found, close out all subsequent proposals that were in the sampling pool using the procedures discussed above.
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- If a contractor has more than one incurred cost proposal (e.g., CFYs 2006 – 2008) and we have no prior experience with the contractor, the audit team should determine the ADV for each proposal and use professional judgment to determine the audit effort that should be performed. For example, if the ADV for the first two years is immaterial (e.g., \$200K and \$500K in CFY 2006 and 2007, respectively), but the ADV for the third year is much more significant (e.g., \$5M), consider assessing the first two years' proposals as low risk and the third year as high risk based on no prior experience. By doing so, not only will we allocate our resources to where there is more risk, but we will also avoid inadvertently assessing the third year proposal where the ADV is significantly higher as low risk based on an audit we performed on a prior year proposal for an immaterial amount. However, if the ADV is consistent across all years, consider utilizing multi-year auditing techniques.

<b>DEFENSE CONTRACT AUDIT AGENCY</b>	
<b>RISK DETERMINATION FOR CONTRACTOR YEARS WITH LESS THAN \$5M IN ADV</b>	
Version No. 3	October 2013

**CONTRACTOR** \_\_\_\_\_ **CFY** \_\_\_\_\_

**DATE CONTRACTOR'S PROPOSAL RECEIVED** \_\_\_\_\_

**IF THIS IS A REIMBURSABLE CONTRACTOR AND WE DO NOT ALREADY HAVE AN AGREEMENT IN PLACE, DO WE HAVE AN AUDIT REQUEST?**      **YES**      **NO**  
 (If no, obtain request before further processing)      \_\_\_\_\_      \_\_\_\_\_

**AMOUNT OF ADV** \_\_\_\_\_ (000)  
 (per incurred cost submission)

*The audit team must use their professional judgment, combined with their knowledge of the contractor and the results of the adequacy review, to determine if there are any significant relevant risks that would warrant the contractor to be classified as high risk and an audit be performed.*

	<b>CRITERIA</b>
1.	<p>Document whether there are significant questioned costs in the last completed incurred cost audit as defined below.</p> <p style="margin-left: 40px;">a. ADV &lt; \$1M: Significant questioned cost is <math>\geq</math> 10% of that year's ADV</p> <p style="margin-left: 40px;">b. ADV \$1M to \$5M: Significant questioned cost is <math>\geq</math> 5% of the that year's ADV or \$100K, whichever is greater</p> <p>Last completed incurred cost audit questioned costs: \$ _____</p> <p>Last completed incurred cost audit ADV: \$ _____</p> <p>Percentage of questioned costs to ADV: _____%</p> <p><i>Refer to Policies and Procedures for Low-Risk Initiative for calculation of ADV and questioned costs.</i></p>
2.	<p>The proposal should be considered low risk unless significant relevant risk material to the incurred cost proposal exists such as:</p> <p style="margin-left: 40px;">a. Known significant fraud referral (Form 2000) applicable to the proposal fiscal year or the period in which the proposal was prepared</p> <p style="margin-left: 40px;">b. Pre-award accounting system performed that resulted in an opinion of "unacceptable," or no previous experience with the contractor such as voucher processing, forward pricing effort, pre-award accounting systems, etc.</p> <p style="margin-left: 40px;">c. Specific risk with the contractor that has material impact to the incurred cost proposal being assessed (i.e., significant CO/Auditor identified risk)</p>



	<p><i>Document below the specific significant risk(s) material to the proposal that support your determination that an audit is warranted. The description must be in sufficient detail to enable an experienced auditor having no previous connection to understand the nature and significance of the risk, and its' relevance to the incurred cost proposal being assessed.</i></p>
	Fraud Considerations:
	Unacceptable Pre-Award or No Previous Experience:
	<p>Specific relevant risk: <i>(Materiality and Impact to the year being assessed must be discussed)</i></p> <p><i>Name of Contracting Officer:</i>  <i>Agency:</i>  <i>Phone Number:</i>  <i>Date Contacted:</i></p>

<b>CLASSIFIED TO:</b>	<b>LOW-RISK POOL</b>	<b>HIGH-RISK POOL</b>	
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**SUPERVISORY REVIEW:** \_\_\_\_\_  
(Supervisor's Signature and Date)

**DEFENSE CONTRACT AUDIT AGENCY  
RISK DETERMINATION FOR CONTRACTOR YEARS WITH \$5M-\$250M IN ADV**

Version No. 3

October 2013

**CONTRACTOR** \_\_\_\_\_ **CFY** \_\_\_\_\_

**DATE CONTRACTOR'S PROPOSAL RECEIVED** \_\_\_\_\_

**IF THIS IS A REIMBURSABLE CONTRACTOR AND WE DO NOT ALREADY HAVE AN AGREEMENT IN PLACE, DO WE HAVE AN AUDIT REQUEST?**      **YES**      **NO**  
 \_\_\_\_\_      \_\_\_\_\_  
*(If no, obtain request before further processing)*

**FOR CONTRACTORS WITH \$100 MILLION TO \$250 MILLION IN ADV, WERE ADEQUACY DETERMINATION LETTERS USED TO CLOSE TWO PRIOR CFYs (i.e., IS THIS THE THIRD UNAUDITED YEAR)?**  
*(A "YES" response indicates proposal must be audited regardless of initial risk).*

**YES** \_\_\_\_\_ **NO** \_\_\_\_\_

**AMOUNT OF ADV** \_\_\_\_\_ (000)  
*(per incurred cost submission)*

*The audit team must use their professional judgment, combined with their knowledge of the contractor and the results of the adequacy review, to determine if there are any significant relevant risks that would warrant the contractor to be classified as high risk and an audit be performed.*

<b>CRITERIA</b>	
1.	Document whether there are significant questioned costs of more than \$250,000 in the last completed incurred cost audit.  Last completed incurred cost audit questioned costs: \$ _____ Last completed incurred cost audit ADV: \$ _____  <i>Refer to Policies and Procedures for Low-Risk Initiative for calculation of ADV and questioned costs.</i>
2.	Document whether there is any significant risk relevant to the incurred cost proposal considering the following: <ul style="list-style-type: none"> <li>a. Known significant fraud referral (Form 2000) applicable to the proposal fiscal year or the period in which the proposal was prepared.</li> <li>b. Pre-award accounting system performed that resulted in an opinion of "unacceptable," or there are reported business system deficiencies relevant to the year under audit</li> <li>c. No previous experience with the contractor such as voucher processing, forward pricing effort, pre-award accounting system, etc.</li> <li>d. Specific risk with the contractor that has significant impact to the incurred cost proposal being assessed (i.e., significant CO/Auditor identified risk)</li> </ul>

**DEFENSE CONTRACT AUDIT AGENCY  
RISK DETERMINATION FOR CONTRACTOR YEARS WITH \$5M-\$250M IN ADV**

Version No. 3

October 2013

	<p><i>Document below the specific significant risk(s) material to the proposal that support your determination that an audit is warranted. The description must be in sufficient detail to enable an experienced auditor having no previous connection to understand the nature and significance of the risk, and its' relevance to the incurred cost proposal being assessed.</i></p>
	<p>Fraud Considerations:</p>
	<p>Unacceptable Pre-Award and/or Other Relevant System Deficiency:</p>
	<p>No Previous Experience:</p>
	<p>Specific relevant risk: <i>(Materiality and Impact to the year being assessed must be discussed)</i></p> <p><i>Name of Contracting Officer:</i>  <i>Agency:</i>  <i>Phone Number:</i>  <i>Date Contacted:</i></p>

<b>CLASSIFIED TO:</b>	<b>LOW-RISK POOL</b>		<b>HIGH-RISK POOL</b>	
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**SUPERVISORY REVIEW:** \_\_\_\_\_  
 (Supervisor's Signature and Date)

Steps	Implementation Plan	Completion Date
1	Complete risk determinations using the revised criteria (Risk Determination Tool V3) for all high-risk proposals <\$5M where an audit has not been started and update DMIS accordingly.	November 29, 2013
2	Complete risk determinations using the revised criteria (Risk Determination Tool V3) for all remaining high-risk proposals < \$250M where an audit has not been started and update DMIS accordingly.	December 13, 2013
3	FAOs will adjust the operating plan as needed to reflect their reassessments.	December 31, 2013
4	OWD will send the new low-risk proposal sample universe to the Regions (Excel Spreadsheet). The assignments in the new universe will be coded LR1Q14 in the sample universe field.	December 3, 2013
5	Regions will reconcile the overall operating plan to staff allocations, and inform OWD when this action is complete.	January 15, 2014
6	OWD will copy the operating plan into the program plan as each Region notifies them that the action in number 5 above is complete.	January 15, 2014
7	Regions will: <ul style="list-style-type: none"> <li>• Where the universe size is sufficient, select a sample on a region-wide basis using the applicable percentage from the revised Policies and Procedures V3 for each universe strata (the number of sample items should be rounded up). If the universe sizes are not sufficient, OWD will select a sample on an Agency-wide basis.</li> <li>• Update the Excel Spreadsheet (annotating the “Sample Code” column with “X” for do not include in sample universe or “Y” for selected for audit).</li> <li>• Submit the updated Excel Spreadsheet to OWD.</li> <li>• Notify FAO which proposals are selected for audit and which will be closed without audit.</li> </ul>	December 20, 2013
8	Using the information provided by the Regions, OWD will update the sample universe and selected for audit fields in DMIS.	December 27, 2013
9	FAOs should complete time phasing of fiscal year 2014 workload and update original due dates in DMIS. The original due date field will be locked as of this date.	January 15, 2014
10	For proposals not selected for audit, FAOs should issue a memo to ACO and disposition the assignment in DMIS.	January 15, 2014 – March 31, 2014

*It is imperative that auditors remember the primary objective of the initiative is to redirect audit effort to completion of high-risk and sampled incurred cost audits, beginning with the earlier year proposals first (i.e., oldest to newest). FAOs should time phase issuance of memorandums to contracting officers for proposals not selected for audit to ensure a workload balance between audits and memos.*

**Milestones Plan**  
**Incurred Cost Proposal Risk Reassessments**

**Filing of Supporting Documentation:** Regions should document their universe review and sample selection process and file the documentation in Livelink under a folder named “720.9.2.7 – Incurred Cost Low-Risk Sample Selection” with subfolders for each sample.

**Coordination with DCMA:** FAOs should coordinate with their respective ACOs to ensure that their time phasing of memos is appropriate and adjust, based on their resources and those of the ACO.