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

IN REPLY REFER TO

PSP 730.5.01.A\2015-008

February 19, 2016
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.

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.

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 Pricing and Special Projects Division at (703) 767-3290 or e-mail at DCAA-PSP@dcaa.mil or Policy Programs Division at (703) 767-2270 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

DISTRIBUTION: E

OFFICE OF THE UNDER SECRETARY OF DEFENSE
3000 DEFENSE PENTAGON
WASHINGTON, DC 20301-3000

ACQUISITION,
TECHNOLOGY
AND LOGISTICS

OCT 24 2014

MEMORANDUM FOR COMMANDER, UNITED STATES SPECIAL OPERATIONS COMMAND (ATTN: ACQUISITION EXECUTIVE)
COMMANDER, UNITED STATES TRANSPORTATION COMMAND (ATTN: ACQUISITION EXECUTIVE)
DEPUTY ASSISTANT SECRETARY OF THE ARMY (PROCUREMENT)
DEPUTY ASSISTANT SECRETARY OF THE NAVY (ACQUISITION AND PROCUREMENT)
DEPUTY ASSISTANT SECRETARY OF THE AIR FORCE (CONTRACTING)
DIRECTORS OF THE DEFENSE AGENCIES
DIRECTORS OF THE DOD FIELD ACTIVITIES

SUBJECT: Use of Blended Rates to Implement Multiple Compensation Caps

The Federal Acquisition Regulation Council issued an interim rule effective on June 24, 2014, revising FAR 31.205-6(p) to establish new allowable cost limitations, initially $487,000, for annual compensation costs incurred on contracts awarded on or after June 24, 2014. The interim rule requirements were established in statute by the Bipartisan Budget Act of 2013. The interim rule is effective for new contracts subject to FAR 31.2 which are awarded on or after June 24, 2014. As required by FAR 52.216-7, contracts subject to FAR 31.2 and awarded prior to this date continue to follow the compensation cap at FAR 31.205-6(p) in effect at the time of contract award.

Many contractors will have contracts subject to both the current and earlier compensation limit provisions in FAR 31.205-6(p), causing the potential for undue complexity and related costs to implement multiple rates to accommodate these revisions. After careful review and consideration of the law and regulations, contractors' use of a "blended rate" approach is deemed as a practical and cost efficient solution to implement these requirements.

Blended rates will be calculated by each individual contractor as a weighted average composite cap amount specific to their contract volume prior to June 24, 2014, and on or after June 24, 2014. Contractors may elect, but are not required, to use the blended rate approach. Depending upon their circumstances, contractors may elect another compliant method (e.g., using the new $487,000 cap for all contracts regardless of award date).

If a contractor proposes to use the blended rate method to cost and propose, the contractor will initially calculate and use a blended rate for interim billing. Subsequently, for the purpose of establishing final overhead rates, contractors will calculate blended rates reflecting actual proportion of contract costs for the current year for contracts prior to and after June 24, 2014. The contractors' final overhead submission for the completed fiscal year must include auditable

substantiation of the calculation of the actual blended rates. An audit will ensure that only the total allowable compensation is billed to the Government for the fiscal year based on the different authorized caps. The objective is to simplify compliance while continuing to protect the interests of the Government.

Contract administration office contracting officers and contractors will execute an advance agreement in accordance with FAR 31.109 with each contractor that chooses to employ the blended rate method. The advance agreement will outline the agreed-to process, auditable data submission and expiration for the application of the blended rates. Additionally, DCMA will issue implementation guidance in coordination with DCAA on this subject.

Shay D. Assad
Director, Defense Pricing

DEFENSE CONTRACT MANAGEMENT AGENCY
3901 A AVENUE, BUILDING 10500
FORT LEE, VA 23801-1809

JAN 2 9 2016

MEMORANDUM FOR CMO COMMANDERS/DIRECTORS
COST AND PRICING CENTER DIRECTOR

SUBJECT: Guidance on the Use of Blended Rates to Implement Multiple Compensation Caps
Target Audience Heads-Up: DCMA ACOs, DACOs, CACOs, Price/Cost Analysts, and Cost Monitors

Background

On October 24, 2014, the Director, Defense Pricing, Acquisition Technology and Logistics OUSD (AT&L) issued a memorandum "Use of Blended Rates to Implement Multiple Compensation Caps." The memorandum stated additional guidance on the implementation of blended rates would be issued by the DCMA in coordination with DCAA. This memorandum provides the information and guidance for implementing and reviewing contractor blending of multiple compensation caps while ensuring the total compensation priced or billed to the Government does not exceed the allowable limits established by law. Hereafter, the term ACO includes corporate administrative contracting officers (CACO), divisional administrative contracting officers (DACO), and ACOs who recommend and/or negotiate final overhead, billing and forward pricing rates.

The Executive Compensation cap is implemented at FAR 31.205-6(p). Contractors are now subject to multiple versions of FAR 31.205-6(p) in the same accounting period based on contract award date and agency. The contract clause at FAR 52.216-7 "Allowable Cost and Payment" applies the version of FAR 31.2 "Contracts with Commercial Organizations" in effect on the date of contract award. Accordingly, the amended FAR 31.205-6(p) "Limitation on allowability of compensation for certain contractor personnel" is applicable only to new contracts awarded on or after the effective date of the FAR revision.

Before 2012:

All US Government contracts entered into prior to December 31, 2011 are subject to the applicable fiscal year (FY) Compensation Cap established by OFPP ($952,308 for 2012) on the 5 most highly compensated employees in management positions at each home office and segment of the contractor, whether or not the home office or segment reports directly to the contractor's headquarters.

2012, 2013, partial 2014:

The executive compensation caps for contracts awarded from January 1, 2012 through June 23, 2014 apply to all contractor employees performing DoD, NASA and Coast Guard contracts, but apply only to the top five executives for the remaining agencies. (Section 803, FY 2012 National Defense Authorization Act, Pub. L.aw 112-81, 125 Stat. 1485 (December 31, 2011)).

Partial 2014 (June 24, 2014 and later):

All US Government contracts awarded by all agencies on or after June 24, 2014 are subject to the $487,000 total executive compensation cap. (Section 702, Bipartisan Budget Act, Pub. Law 113-67, 127 Stat. 1165 (December 26, 2013)).

The executive compensation caps by year are:

$693,951 in 2010
$763,029 in 2011
$952,308 in 2012
$487,000 beginning on June 24, 2014

Note: OFPP has not published the 2013 and 2014 (prior to June24) limitations as of the date of this guidance.

Blended Compensation CAP

The cap amount for each year should be calculated as a weighted average by blending the separate cap amounts based on the contract actions entered into before June 24, 2014 and on or after June 24, 2014. The relative percentage that the new cap (effective on or after June 24, 2014) contributes to the blended rates will increase over time as the business mix shifts from modifications to older contracts (prior to June 24, 2014) to new contracts. This method does not require the contractor to develop multiple sets of rates and relies on the contractor's existing cost accounting practices and processes to apply the cap to all contracts subject to FAR 31.205-6(p). The contractor should be required to demonstrate the accuracy of their calculations based on their accounting records and to provide objective, auditable support for the basis selected for forward pricing rates, interim billing rates, and final incurred cost rates. The information used to calculate the blending should be consistent in quantum and detail with the information used to calculate the proposed rates.

Final Overhead Rates:

ACOs are to require contractors to identify the universe of contracts or other actions for which the final overhead rates are to be applied. A blended compensation cap is to be calculated based on the proportion of dollars incurred on contracts awarded before and on or after June 24, 2014. DCAA audits the data provided by the contractor for the fiscal year to ensure proper calculation of the actual blended compensation caps in its final overhead rate proposal. The audit ensures only the allowable compensation is billed each fiscal year based on the different authorized caps.

Interim Billing and Forward Pricing Rates

For each year included in an initial forward pricing rate proposal, revised proposal(s), and/or an update of an existing rate agreement as a result of cost monitoring activities, ACOs are to require the contractor to identify in writing the estimated universe of contracts or other actions

to which the forward pricing rates are applied (excluding the costs of contracts already priced (backlog)). ACOs are to require the contractor to identify in writing the estimated universe of contracts or other actions to which the interim billing rates are applied. Each universe identifies the volume of costs estimated to be priced by year applicable to contracts awarded before and on or after June 24, 2014. Blended compensation caps for each year of the FPRP are to be calculated based on this information. The ACO, considering advice by DCAA, determines if the total proposed compensation to be priced on Government contracts throughout the period of the FPRP exceeds the total allowable compensation.

Implementation

When a contractor chooses to use a blended compensation cap, the ACO must execute an advance agreement, as provided for in FAR 31.109 (Advance agreements). The advance agreement is used to set forth the agreed to process and frequency for providing auditable data necessary to support the calculation and application of the blended compensation cap for forward pricing, interim billing, and final rates, and the expiration date for the ending of the blended compensation cap estimating method. The ACO must invite DCAA to participate in prenegotiation review and subsequent negotiation discussions. More details on the use of advance agreements, including the template for advance agreement are found in Question #17 below.

The following Q&As are provided as the guidance referred to in Mr. Assad's memo dated October 24, 2014.

Guidance on the Implementation of Blended Compensation Caps

Question #1: Is blending a cost accounting practice change for a contractor?

No. This is not considered a cost accounting practice change. Contractors should continue to follow their existing cost accounting practices for applying the compensation cap determined by blending.

Question #2: Are any special calculations needed for 2014 since the implementing FAR rule wasn't effective until June 24, 2014?

No. The blending methodology effectively takes into consideration the contract mix before and on or after June 24, 2014.

Question #3: Must all contractors use the blended rate methods?

No. This method is optional for contractors. Each contractor selects a method appropriate for their circumstances. Methods other than blending are also acceptable (e.g., using the new compensation cap effective on or after June 24, 2014 for all contracts regardless of award date, using multiple rates at each cap amount and applied to contracts based on award date).

Question #4: Is the blended rate always of the $952,308 and $487,000 cap amounts?

No. The statutes for both of these cap amounts provide for periodic re-evaluation. Revised cap amounts for contracts prior to June 24, 2014 have been published in the Federal Register by OMB (https://www.whitehouse.gov/omb/procurement_index_exec_comp). Revised cap amounts for contracts on or after June 24, 2014 are available at http://whitehouse.gov/omb/procurement/cecp. The blended rate for each year is to be based on the cap amounts from these two sources applicable to the year for which it is being calculated.

Question #5: Which contracts and subcontracts are considered "affected contracts" and are therefore included in dollar amounts used to calculate the blended rate?

Contracts subject to FAR 31.2 are included (e.g., firm-fixed-price, fixed-price, fixed-price incentive, cost-reimbursement, etc.). Contracts not subject to FAR 31.2 are excluded, such as those for commercial items. Contracts for non-US Government customers are excluded. Foreign Military Sales (FMS) contracts are included, but direct sales contracts to other governments are excluded. For forward pricing rates, contract awards that have already been priced (referred to as backlog) are not be affected by the forward pricing rates and should therefore be excluded.

Question #6: Are forward pricing/interim billing and final overhead rates using blended compensation cap be computed with consideration of the same "*affected* contracts"?

No. Since the blended compensation cap for final overhead rates is used by the contractor to calculate allowable and billable costs for all contracts incurring costs during the year it is computed using contracts awarded and incurring cost in the current year as well as costs of contracts awarded previously. Since the blended compensation cap for forward pricing rates is only used to price new work, it is computed using new contract awards and other contract actions (e.g. modifications) to existing contracts to be awarded during the year. Interim billing rates generally follow the method used for forward pricing. The contracting officer can choose to calculate a separate compensation cap using the contracts to be affected by the billing rates when required to more closely approximate the final indirect cost rates. The circumstances for this variation should be spelled out in the advance agreement.

Question #7: Can you provide illustrations of how the blended rate calculations could be made?

Below are illustrations of how a contractor could calculate the blended rate.

Final overhead rates

This example uses a weighted average of the cap amount applicable to contracts awarded prior to June 24, 2014 and the cap amount applicable to contracts awarded on or after June 24, 2014 based on the compensation dollar amounts for those contracts and subcontracts incurred for the accounting period. Contractors can propose a methodology that makes sense and is verifiable for their situation and DCMA, in coordination with DCAA, is to determine if the proposed blending methodology is equitable prior to signing the advance agreement.

Step 1: Identify the dollar amounts incurred for the year for contracts and subcontracts awarded prior to June 24, 2014 and from contracts and subcontracts awarded on or after June 24, 2014. This constitutes 100 percent of contract dollars for final overhead cost calculations. Determine the percentage of the total dollar amounts attributable to contracts awarded prior to June 24, 2014, and the percentage of the total dollar amounts for contracts awarded on and after June 24, 2014.

In the illustration shown in the table below, for 2014, the cost incurred for contracts awarded prior to June 24, 2014 are $900,000, and dollars for contracts awarded on or after June 24, 2014 are $100,000. The dollars for contracts awarded prior to June 24, 2014 are 90% of the total ($900,000/$1,000,000), and those awarded on or after June 24, 2014 are 10% ($100,000/$1,000,000).

Step 2: Identify the cap amounts pertinent to each contract award period as discussed in response to question #4. In the illustration shown in the table below, the cap amounts for "old" contracts awarded before June 24, 2014 is $952,000 and for "new" contracts awarded on or after June 24, 2014 is $487,000 (This illustration assumes the contractor is on a calendar year).

Step 3: Multiply each cap amount by the respective contract dollar amount percentage determined in Step 1. Add the two amounts. This is the blended compensation cap that the contractor applies for the year as part of the established cost accounting practice. In the illustration shown in the table below, the contractor calculates a blended rate for 2014 of $906,000. This is the weighted average of the two cap amounts based on business volume. Shown mathematically, the detailed calculation is: ($952,000 x 90%) + ($487,000 x 10%) = $906,000.

Year	(Contract before 6/24/14)	(Contract on or after 6/24/14)	% old	% new	old cap ($K)	new cap ($K)	Blended Cap ($K)
2014	$900,000	$100,000	90%	10%	$952	$487	$906

Forward Pricing Rates

Step 1: Identify the dollar amounts proposed to be priced for each year included in the proposal for contracts and subcontracts awarded prior to June 24, 2014 and from contracts and subcontracts awarded on or after June 24, 2014. This constitutes 100 percent of contract dollars to be priced using the blended rate. Determine the percentage of the total dollar amounts for proposed contract actions attributable to contracts awarded prior to June 24, 2014, and the percentage of the total dollar amounts for proposed contract actions awarded on and after June 24, 2014. In the illustration shown in the table below, for 2015, the dollars proposed to be awarded in 2015 for contracts awarded prior to June 24, 2014 are $10,000, and dollars proposed to be awarded in 2015 contracts awarded on or after June 24, 2014 are $190,000, for a total of $200,000. The dollars for contracts awarded prior to June 24, 2014 are 5% of the total ($10,000/$200,000), and those awarded on or after June 24, 2014 are 95% ($190,000/$200,000).

As previously stated, for forward pricing rates, contract dollars already priced (backlog) are not affected by the forward pricing rates and should be excluded.

Step 2: Identify the cap amounts pertinent to each contract award period as discussed in response to question #4. In the illustration shown in the table below, the cap amounts for "old" contracts awarded before June 24, 2014 is $952,000 and for "new" contracts awarded on or after June 24, 2014 is $487,000 (This illustration assumes the contractor is on a calendar year).

Step 3: Multiply each cap amount by the respective contract dollar amount percentage determined in Step 1. Add the two amounts. This is the blended compensation cap that the contractor is to apply for the year as part of the established cost accounting practice. In the illustration shown in the table below, the contractor calculated a blended rate for 2014 of $510,250. This is the weighted average of the two cap amounts based on business volume. Shown mathematically, the detailed calculation is: ($952,000 x 5%) + ($487,000 x 95%) = $510,250.

		New Pricing (e.g. Modification)	New Pricing					
Year	Backlog - Already Priced Not Affected by Forward Pricing Rates	(Contract before 6/24/14)	(Contract on or after 6/24/14)	% old	% new	old cap ($K)	new cap ($K)	Blended Cap ($K)
2015	$750,000	$10,000	$190,000	5%	95%	$952	$487	$510.25
2016	$500,000	$10,000	$490,000	2%	98%	$952	$487	$496.30
2017	$300,000	$10,000	$740,000	1%	99%	$952	$487	$493.20
2018	$150,000	$10,000	$840,000	1%	99%	$952	$487	$492.47
2019	$ -	$10,000	$990,000	1%	99%	$952	$487	$491.65

Question #8: Are the Blended rates determined by the contractor as a whole, by division, or by each segment of the contractor?

The contractor should propose an approach to the Government, and demonstrate and support its approach prior to the advance agreement being signed. The ACO reviews the viability of the approach in consultation with DCAA to ensure an allowability of total compensation can be determined. The approved approach and requirements to support the rates must be detailed in the advance agreements. The blending of the cap amounts should be consistent with how the contractor provides its incurred cost submissions.

Question #9: How long can the contractor use the blended rate?

The length of time a contractor uses the blended rate depends on whether the contractor continues to incur or price costs on affected contracts that were awarded prior to the June 24,

2014 date. As long as costs are incurred or priced on affected contracts awarded before that date, the blending of the cap amounts may be permitted.

Question #10: How often will a blended compensation caps be calculated by the contractor?

Typically a contractor will calculate the blended cap at least twice for each year. The first calculation for the year is to establish forward pricing and proposed interim billing rates based upon a **forecast** of the proportion of dollars for contracts awarded prior to June 24, 2014 and the dollars for contracts awarded on or after June 24, 2014. In cases where a contractor is awarded a significant contract not anticipated after establishing blended interim billing rates, the contractor may need to re-calculate the cap considering the impact of the award. The second calculation for the year is to establish final overhead rates based upon the **actual** proportion of dollar amounts from contracts awarded prior to June 24, 2014 and those awarded on or after June 24, 2014. Contractors' calculations of the blended compensation caps should be included as a separate schedule in the submittals. This requirement is included in an advance agreement. The blended compensation cap established for forward pricing may occur more frequently. The contractor should ensure the blended compensation cap is updated and consistent with the FPRP for every update provided throughout the year.

Question #11: In computing the dollar amounts used to calculate the blended rate, are delivery orders issued on or after June 24, 2014 related to a Basic Ordering Agreement (BOA) awarded prior to June 24, 2014 considered to be prior to June 24, 2014 like the BOA or on or after June 24, 2014 when the order was issued?

The BOA is not a contract. Each delivery order related to the BOA is considered a new and separate contract award with the clause at FAR 52.216-7 that relies on FAR 31.2 in effect at the time of the order. Therefore, for purpose of calculating the blended rate, delivery orders are considered based on their award date(s), in this case on or after June 24, 2014, not that of the BOA.

Question #12: In computing the dollar amounts used to calculate the blended rate, are task orders issued on or after June 24, 2014 related to an Indefinite Delivery/indefinite Quantity (IDIQ) contract awarded prior to June 24, 2014 considered to be prior to June 24, 2014 like the IDIQ, or on or after June 24, 2014 when the order was issued?

The IDIQ is a contract with the clause at FAR 52.216-7 subject to the FAR 31.2 in effect at the time of the award, which in this case is prior to June 24, 2014. Each task order awarded related to the IDIQ continues to rely on the original IDIQ contract with the FAR 52.216-7 and FAR 31.2 in effect at the time of the IDIQ award, which in this case is prior to June 24, 2014. For purposes of calculating the blended rate, the orders are considered based on the award date of the IDIQ contract.

Question #13: In computing the dollar amounts used to calculate the blended rate, are the dollar amounts of contract modifications made on or after June 24, 2014 to a contract awarded prior to June 24, 2014 considered prior to or on or after June 24, 2014?

A contract with the clause at FAR 52.216-7 is subject to the FAR 31.2 in effect at the time of award, in this case prior to June 24, 2014. Modification is not a new contract, so it would be subject to FAR 31.2 in effect at the time of the initial contract award. Since the contractually applicable cap is the one prior to June 24, 2014, for purposes of calculating the blended rate, the dollar amounts for this modification are subject to the cap at time of contract award, prior to June 24, 2014.

Question #14: In computing the dollar amounts used to calculate the blended rate, are contract options exercised on or after June 24, 2014 from a contract awarded prior to June 24, 2014 considered prior to or on or after June 24,2014?

Properly exercised options are priced under the cap in effect at the time the original contract is awarded. The original contract has the FAR 52.216-7 clause and is subject to FAR 31.2 in effect at the time of the award, in this case prior to June 24, 2014. However, if the exercise of the options results in a new contract on or after June 24, 2014, the new contract is subject to FAR 31.2 in effect on or after June 24, 2014. Therefore, for purposes of the blended rate, the cap dollar amount for the resulting new contract from the exercise of the options is the cap set on or after June 24, 2014.

Question #15: What coordination is necessary with DCAA?

Prior to signing an advance agreement or accepting a methodology, the ACO, in accordance with FAR 31.109(f)(3), as appropriate, must invite DCAA, to review the computation of the compensation cap, and participate in prenegotiation discussions and /or subsequent negotiations. DCAA identifies contractor proposed processes and calculations that could result in the executive compensation that exceeds the allowable cap. For forward Pricing Rates and final Overhead Rates, the ACO must follow the guidance in DCMA-INST 130 "Forward Pricing Rates" and DCMA-INST 125 "Final Overhead Rates."

Question #16: What must the ACO do to resolve and/or disposition the audit report which takes exception to the proposed forward pricing rates using blended cap?

The ACO has the responsibility to prevent the total proposed compensation to be priced on Government contracts throughout the period of the FPRP from exceeding the total allowable compensation. DCAA identifies questioned costs when their review indicates the total proposed compensation exceeds the total allowable compensation in FPRPs. Accordingly, the ACO must clearly address the DCAA findings related to blended compensation caps included in rates in a separate line item in the PNOM or MFR. The ACO must follow the process in DCMA-INST 126 "Contract Audit Follow Up" to resolve and/or disposition the audit report.

Question #17: Do I need an advance agreement with the contractor prior to using a blended compensation cap method for establishing rates?

Yes, a template below is provided for your use.

[Advance Agreement Template]

ADVANCE AGREEMENT FOR BLENDED RATES BETWEEN THE UNITED STATES GOVERNMENT AND [CONTRACTOR FULL NAME]

This Advance Agreement ("Agreement") is entered into between the Department of Defense, represented by the Defense Contract Management Agency, on behalf of the United States Government ("Government") and [Contractor Full Name], on its own behalf and on behalf of its affected Business Units (hereinafter referred to collectively as "Contractor"). The Government and the Contractor are collectively referred to herein as "the Parties."

This Agreement is entered into by the Parties under the authority of Federal Acquisition Regulation ("FAR") 31.109, "Advance Agreements," FAR 31.205-6(p), "Limitation on Allowability of Compensation," and Cost Accounting Standard ("CAS") 48 C.F.R. 9904.405, "Accounting for Unallowable Costs." Additionally, this Agreement is entered into in accordance with the Director, Defense Pricing Acquisition Technology and Logistics OUSD (AT&L) memorandum dated October 24, 2014 to implement the use of composite compensation cap amounts ("blended rates") for executive compensation.

This Agreement is effective upon signature by both parties, and unless cancelled under the provisions herein, remains effective until [MMM DD, YYYY], as to all identified costs properly recorded in Contractor's FY [XXXX-YYYY] accounting periods.

Now THEREFORE, the Parties hereby agree as follows:

1. The Parties will discharge their respective responsibilities to develop a transitional compensation cap amount for Contractor by using the blended rate methodology detailed in Paragraph 2.

2. [Insert details regarding the approved methodology. Specifics will vary by Company.]

3. Contractor will submit interim billing rates and forward pricing rates based on a forecast of the proportion of dollars for affected contracts and pricing actions for contracts awarded prior to June 24, 2014, and contracts awarded on or after June 24, 2014 using the methodology agreed to above. Contractor also agrees that if they are awarded a significant contract, or anticipate significant variance in costs to be incurred that was not considered when establishing blended interim billing rates, or if they identify changes to future years forecasted base amounts used in establishing the blended forward pricing rates they will do an assessment to determine if a re-calculation is necessary.

4. Contractor agrees to include a detailed schedule demonstrating the calculation of the blended rates using the methodology agreed to in Paragraph 2 in their final overhead rate submission. Contractor must demonstrate the accuracy of their calculations based on their accounting records, and maintain sufficient records for audit and negotiation of final overhead rates.

5. Contractor agrees to include a detailed schedule in the forward pricing rate submission demonstrating the blended rates calculated using the method described above does not result in pricing total compensation to the Government in excess of that allowed by the terms of anticipated contracts. Contractor understands and acknowledges that a corresponding adjustment to proposed rates to remove unallowable excess compensation costs above the compensation limits will be made once the DCAA audit is complete.

6. The Government has the right to, at any time, review the Contractor's blended rates and supporting documentation for accuracy and compliance with the terms of this Agreement and the authorities cited herein.

7. The Government agrees to authorize Contractor's use of the blended rates when it is determined that the blended rates are accurate and comply with the terms of this Agreement, the authorities cited herein, and any and all applicable authorities.

8. This Agreement applies to all Government flexibly-priced contracts and subcontracts performed by Contractor during FY XXXX-YYYY. Such contracts and the affected business units are identified in Attachment 1.

9. This Agreement establishes no precedent concerning the allowability, allocability or reasonableness of costs incurred by Contractor.

10. This Agreement does not change any costs or rate ceiling, or any specific allowance or disallowance, established by the terms and conditions of any contract to which this Agreement applies.

11. If the terms of this Agreement conflict with the terms of a Government contract to which this Agreement applies, the terms of the contract shall take precedence.

12. The parties retain the right to unilaterally and immediately cancel this agreement upon written notification to the other party. However, it is understood that each party will give the other party at least 30 calendar days' written notice, unless urgent and compelling reasons exist, prior to cancelling the Agreement.

13. The invalidation of any segregable phrase(s), provision(s), or clause(s) of this Agreement shall not affect the validity of any of the remaining portions of this Agreement. No delay or failure of the Government in exercising any right, power, privilege, or remedy under this Agreement shall affect or waive any such right, power, privilege, or remedy, or impair any further exercise thereof.

14. Any changes to this Agreement must be executed in writing by the Parties with signatures of authorized officials of the Parties.

15. The data contained in this Agreement shall not be disclosed outside the Government, nor shall it be duplicated, used or disclosed in whole or in part for any purpose other than as authorized by law or regulation.

16. The undersigned official of Contractor warrants, by signature, that he or she has the proper authority to execute this Agreement on behalf of Contractor.

THE UNITED STATES GOVERNMENT	CONTRACTOR
Signed: _____	Signed: _____
Name: _____	Name: _____
Title: _____	Title: _____
Date: _____	Date: _____

[End of the Template]

Conclusion

This guidance was developed in coordination with DCAA. It provides a practical methodology for implementing the requirements of section 702 of the Bipartisan Budge Acts of 2013 and its application will only remain in effect for a limited number of years. Thus, this guidance will not be incorporated into a current instruction and/or future manual. It will be posted to the FPRA resource page.

Questions related to this memorandum should be directed to Mr. Luke S. Baey, DCMA-AQD, (804)416-9190 or by e-mail at luke.baey@dcma.mil.

Timothy P. Callahan
Executive Director, Contracts

Attachment(s):
TAB A. Memorandum for Guidance on the Use of Blended Rates to Implement Multiple Compensation Caps issued by the Director, Defense Pricing, on October 24, 2014

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 Estimated TCI for Modifications to pre 6/24/14 Contracts (New Pricing)	B TCI for Estimated Future Effort (New Pricing)	A+B=C TCI	A/C*952=D Weighted Cap on Pre 6/24/14	B/C*487=E Weighted Cap on Post 6/24/14	D+E 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	5,000	1,000	4,000	6,000	
Proposed Net Allowable Costs	$ 477,315	$ 255,036	$ 888,748	$ 767,056	
DCAA Questioned Costs					
Costs in Excess of Compensation Cap	$ 1,000	$ 250	$ 2,481	$ 2,000	
Audit Established Net Allowable	$ 476,315	$ 254,786	$ 886,267	$ 765,056	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.