

**Complying With DCAA
(Defense Contract Audit Agency)**

Project Cost Accounting for Government Contractors

EXECUTIVE GUIDE SERIES

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Executive Summary

In a commercial contract, the deliverable is a package of goods and services. In a government contract, there's another ingredient for the contractor to reckon with: administrative reporting to assure that costs billed to the contract are allowable by the government. In this sense, "reporting" means not only routinely submitted reports such as detailed justification for contract billing, but also **the ability to produce on-demand responses to government auditors' requests** for information.

In the United States, the agency primarily responsible for monitoring government contractors' compliance and reporting is the Defense Contract Audit Agency. Established in 1965, the DCAA reports to the Department of Defense Comptroller. It has about 4,000 employees, 36% of whom are CPAs, in five regions. DCAA reviews US DoD and other government agency contracts.

The agency's heaviest scrutiny falls on contracts with "cost-plus" or other cost reimbursement provisions. Failure to comply has significant penalties, risks and costs for contractors.

To win a coveted government contract, a contractor must incorporate DCAA compliance into its pre-proposal planning. Before the award, the contractor may need to devote extensive resources to justifying its proposed costs. In the post-award phase, a first-time government contractor may need to implement processes for entirely new reporting requirements.

In general, to comply with DCAA standards, a contractor must:

- Be prepared for various types of audits, including extensive pre-award proposal and system reviews
- Use manual effort if necessary to compensate for any deficiencies in its accounting and reporting systems
- Keep stringent timekeeping records that track employees' time on work activities
- Maintain highly detailed, accurate accounting records of costs incurred, with accurate differentiation of direct and indirect costs.

How difficult is DCAA compliance for government contractors? A key determinant is the quality of systems and processes the contractor has in place to comply.

Contractors that rely on piecing together information from disparate sources are at a competitive disadvantage. Inefficient procedures and poor controls typically leave these contractors ill-prepared for audits. Moreover, these contractors are vulnerable to a host of penalties or other consequences of non-compliance.

For other contractors, DCAA compliance and audit preparation is a non-disruptive, routine process. For all projects in both government and private sectors, these contractors use project planning and workforce management systems to gain better control, efficiency and profitability. *DCAA compliance is a by-product of their focus on strong project workforce management.*

This paper highlights:

- What DCAA requires from contractors
- The challenges of compliance
- How a project workforce management system facilitates compliance and prepares contractors for DCAA audits.

The ABCs of DCAA

DCAA's mission is to provide professional accounting and administrative advice to federal government procurement personnel at all stages of the procurement process, including: pre-negotiation, negotiation, administration and settlement (contract closing).

Most audits of federal government contracts – even those issued by non-DoD agencies – are performed by the DCAA:

DCAA's primary customers are contracting officers in the Department of the Army, Department of the Navy, Department of the Air Force, and Defense Contract Management Agency. Audit services provided by DCAA are key to making contract decisions; they help contracting officers ensure that DoD components obtain the best value from the goods and services they purchase. DCAA also performs – on a reimbursable basis – the majority of contract audit services for all other federal agencies.¹

When a new contractor's proposal is submitted, a contracting officer of the buying agency—the Navy, for example—may request DCAA's pre-award auditing services. After a contractor has been awarded a contract, DCAA conducts audits either on its own initiative or at the request of the buying agency.

¹ "Fiscal Year 2007 Budget Estimates," February 2006, page 18. Accessed at http://www.dod.mil/comptroller/defbudget/fy2007/budget_justification/pdfs/operation/om_vol_i_parts/DCAA.pdf

Challenges of DCAA Compliance

1. You never know when you will be audited by the DCAA

The timing and intensity of DCAA involvement depends on the type of contract awarded. For fixed price contracts and time and material (T&M) rates, most of DCAA's auditing efforts take place during the proposal stage. For flexibly-priced contracts, such as "cost plus fixed fee," DCAA gets involved with the contractor as costs are incurred.

2. You never know what a DCAA audit will focus on

Contractors must be prepared for a wide range of different types of audits. The DCAA's "Fiscal 2007 Budget Estimates" describes more than a dozen different audits covering everything from proposal pricing and contractor stability to internal controls and termination claims. Audits can be pre-award or post-award—and some fit in both timeframes. Some audits are announced and some are unannounced. Some are desk audits, where DCAA auditors perform the audit at their offices. The sidebar briefly explains some of the more common types of DCAA audits.

DCAA Audits You Could Receive

While there are many specific types of DCAA audits, most are in two categories: system audits and financial audits.

1. **A system audit** is performed to determine the acceptability of a contractor's systems for estimating, accumulating, and controlling costs under a government contract. These reviews may recommend corrective actions on conditions causing deficiencies which require immediate reporting and resolution.
 - A system audit is typically part of a pre-award survey to assess the contractor's financial ability to perform the contract.
 - "Floor checks" are a specific type of post-award system audit. DCAA conducts these unannounced audits to determine the adequacy and accuracy of the timekeeping system for reimbursement of labor costs under cost reimbursable contracts. Floor checks include physical observations of work areas and questioning of employees to determine if employees exist, are actually at work, and are performing in their assigned job classification. The auditors also want to know if employee time is charged to the appropriate job or indirect account.

2. **Financial audits.** The primary goal of DCAA financial audits is to determine if government funds are being spent in accordance with various rules and regulations.

- Price proposal audits are performed to determine the reasonableness of contractors' price proposals submitted in anticipation of negotiating government contracts. Requested by contracting officers, these audits must be accomplished within a short period to avoid delaying the procurement process. Price proposal audits usually include a "cost realism analysis" to ensure that proposed costs are not significantly understated.
- Incurred cost audits include reviews of direct labor and material, indirect expenses, and performance and financial controls. This audit's primary purpose is to weigh the acceptability of claimed costs submitted by contractors for reimbursement under flexibly priced contracts.
- Cost accounting reviews. DCAA is responsible for reviewing contractors' implementation and compliance with the government's cost accounting rules and regulations.

3. The time and costs of compliance can be burdensome

Without effective project planning, compliance preparation and automated support systems in place, government contractors may see their expected profits quickly turn into losses.

At the pre-award stage, huge amounts of time and resources may be needed to create manual procedures, documents and spreadsheets just to collect information needed for basic compliance. Clearly, DCAA expects contractors to be prepared to back up their proposals with very detailed information:

... the contractor should have available detailed schedules of the labor and overhead rates used in the proposal. The schedules should show computations and tie into the existing accounting system. The schedules should also present the historical data and the rationale used in deriving future projections. They exclude all unallowable costs.²

² "Information for Contractors," DCAAP 7641.90, January 2005, page 3-13. Accessed at <http://www.dcaa.mil/>

After contracts are awarded, contractors deal with the realities of ongoing compliance and the ever-present possibility of audits. First-time government contractors need to gather, maintain, verify, compile and report new types of data to government agencies—in the form of DCAA-compliant invoices, audit responses, or other reports. Responding to an adverse audit can cause more waste of time and resources.

Error correction is one example of a compliance task that can get out of control for new government contractors. Experience shows that contractors, when implementing manual procedures to cope with DCAA requirements, often make mistakes. Some industry experts estimate that up to 25 percent of time and expense records, for example, are submitted with errors and must be reprocessed.

4. Federal accounting standards pose new challenges

As a condition of government contracting, many contractors must follow federal cost accounting standards. Contracts and subcontracts not qualifying for any of several exemptions are subject to the cost accounting standards, which involves the assignment, measurement and allocation of costs. DCAA has responsibility for reviewing contractors' implementation and compliance with the standards.

A government contracting consultant, Tony Fuller of Beers & Cutler PLLC, explains how cost accounting can intimidate contractors new to cost-plus contracts:

Once companies enter the world of cost-plus contracting, they often find they are now subject to increased audit scrutiny, even involving fixed-price and time-and-materials contracts being subject to audit procedures. Cost-plus contracts typically lead to audits of companies' entire cost-accounting systems, which include other types of contracts. The audits will likely look at processes such as cost accumulation, time charging, indirect cost allocation and invoicing that cover all types of contracts, not just cost-reimbursable contracts.³

DCAA auditors will look for compliance with key principles of cost accounting. Some of these principles include:

- All costs must ultimately be identified with a contract, either directly or by allocation of indirect expenses.

³ "Online Forum: Preparing for Federal Contract Audits," Roseanne Gerin, forum moderator, *Washington Technology*, 25 January 2006. Accessed at <http://www.washingtontechnology.com/news/forum/forums/27787-2.html>

- A contractor's accounting system must differentiate between direct and indirect costs or it will be deemed inadequate for government contracts.
- **Direct costs** benefit one cost objective—the contract. Examples of direct costs:
 - Specialized training for electricians to meet the contract's requirements
 - Leasing costs of a truck used only for work at the contract's job site
- **Indirect costs** are costs that cannot be identified directly to a single contract. Indirect costs benefit multiple contracts or cost objectives. General categories of indirect costs include general administration (accounting, payroll, purchasing, etc.), sponsored project administration, general business travel, plant operation and maintenance, departmental administration expenses, and depreciation or use allowance for buildings and equipment. Examples of specific indirect costs:
 - Company-sponsored training not related to a specific contract
 - Leasing costs of a multi-use corporate truck
- Unallowable costs that cannot be submitted for reimbursement include alcoholic beverages, entertainment, gifts, and first-class travel accommodations. A good rule-of-thumb: anything that is considered “fun” or “extravagant” cannot be charged off.
- Costs that cannot be allocated are treated as unallowable costs.

5. Inadequate compliance has many adverse consequences

A government contractor is responsible for appropriately accounting for costs and for maintaining records, which includes providing supporting documentation to adequately demonstrate that costs claimed have been incurred, are allocable to the contract, and comply with applicable cost principles in this subpart and agency supplements. Auditors, or the contracting officer, may disallow all or part of a claimed cost which is inadequately supported.

For deceitful claims, such as improper recording of employee time, the penalties can be much more severe, including criminal charges, fines, loss of contract, and loss of standing as a DoD contractor.

Even if no costs are disallowed, poor recordkeeping could still result in adverse consequences and opportunity costs. Weak internal controls can undermine the contractor's profitability and competitiveness. Pre-award audits may conclude that the cost accounting systems are inadequate. Allowable costs may be overlooked. Errors and delays in claims may hurt cash flow. Auditors who “smell blood” may submit every claim for closer examination.

Approaches to Meeting These Challenges

Contractors face rigid requirements in *what* is acceptable under DCAA guidelines – but they have a great deal of flexibility in *how* to comply. For example, in audit situations, DCAA auditors don't specify exact format requirements for supporting documentation. Nor do they require that the documentation be produced by automated systems.

What are the alternatives for complying with auditors' expectations?

Manual patches. Some contractors chose to comply by adding staff to compile data and perform processes that demonstrate a “system.” All too often, the result is an assortment of disparate systems connected only by manual processes, redundant data entry and spreadsheet reporting.

Software solutions. A wide range of commercially available systems claim to provide varying levels of DCAA compliance. Some are single-function, desktop “point solutions” for timekeeping, or project management, or cost accounting.

At the other extreme are expensive, do-everything systems that may comply fully with DCAA requirements, but probably don't comply with your needs for affordability, ease of implementation and ease of use. Often, blockbuster-type solutions foster user dependency on the vendor's rigid approach to doing things, rather than adapting to a contractor's business needs.

What would impress DCAA?

Is there an ideal balance between the underperformance and overkill alternatives? Yes. A later section of this paper will describe Tenrox's solution, which consists of integrated timesheet, project planning, and project management systems—with built-in DCAA compliance features.

But first, consider what an ideal solution would do from a DCAA auditor's perspective. When the agency conducts a pre-award systems audit, what does it want to find out about the contractor's accounting systems? Here are some of the main questions auditors will have:

1. Can the project accounting system segregate direct costs from indirect costs?
2. Can the project accounting system accumulate costs by contract (commonly referred to as a job costing system)?
3. Is there a logical and consistent method for the allocation of indirect costs to the contract?
4. Can the job costing system be reconciled with the general ledger?

5. Can the timekeeping system track employees' time spent on each work activity?
6. Does the timekeeping system provide the appropriate controls and audits that meet the timekeeping requirements of DCAA?
7. Can the timekeeping system charge direct and indirect labor to the appropriate cost centers?
8. Can the timekeeping system provide detailed calculations and reporting on the cost of labor for all resources working on DCAA contracts?
9. Is there a segregation of responsibilities for labor-related activities? For example, is the responsibility for timekeeping and payroll accounting separated?
10. Can the project accounting system produce appropriate reports, on a monthly or more frequent basis, that show the results of charges to contracts?
11. Can the project accounting system identify unallowable costs and segregate them in the books and records?

Certainly, this is not an all-encompassing list of attributes a solution should have to be DCAA-compliant. But it does reveal key functionality that should be present to address the primary compliance issues.

What Tenrox customers want

To the auditor's list, Tenrox would add other key design features that originated as requests from our customers. Foremost on their list is that **DCAA compliance should be tightly integrated with an overall project workforce management solution**. This approach enables the government contractor to extend key benefits and efficiencies of project workforce management to a much broader scope of managing the business.

In other words, Tenrox customers view DCAA compliance as a by-product of the enterprise-wide benefits that spring from robust project workforce management. These benefits include:

- Connecting all aspects of a project – from project initiation and definition through report analytics – to concrete performance goals
- Freeing the enterprise to capitalize on the fast-paced, fragmented, collaborative nature of modern business
- Tracking and reporting any combination of work elements to meet the demands of ever-shifting initiatives, priorities, resources and milestones
- Enabling decision-makers to gain total visibility and control of every project
- Gaining new insights and opportunities for performance improvement by leveraging all relevant information

The Tenrox Solution for Project Workforce Management—and DCAA Compliance

Project Workforce Management integrates the capabilities and goals of three vital applications:

1. Project management
2. Workforce management
3. Financials

It maintains a real-time global “system of record” to connect data from the customer, the project and the workforce without the limitations of geographic boundaries or reporting hierarchies.

For company project managers and decision-makers, Tenrox Project Workforce Management will:

- Provide a standard framework for defining project plans, objectives and milestones
- Match people to project positions based on skills and availability
- Show detailed project information for any combination of criteria—in real-time at any location
- Facilitate the implementation of formal policies and processes for overhead charge back, revenue recognition, timesheet management and cost allocation
- Graphically define, control, track and audit all assignments, approvals, modifications, routing and notifications
- Consolidate data in a single, traceable, auditable source for project management, workforce management, timekeeping, payroll and cost accounting applications

For compliance managers and DCAA auditors, Tenrox Project Workforce Management will:

- Show trends and cost breakdowns to provide a basis for evaluating the reasonableness of proposed rates
- Eliminate reliance on ad-hoc manual approaches to answering auditor inquiries
- Provide time-phased analyses of labor hours, rates and cost by category
- Track and report true costs against government contracts
- Provide a flexible cost rate platform for tracking wages, salaries, equipment, and materials
- Allocate and track time by differentiated descriptions
- Invoice government customers on a contract basis for all spending and labor costs based on agreed billing schedules
- Maintain cumulative allowable costs by contract to support interim and final vouchers

The table below shows examples of how Tenrox Project Workforce Management meets specific DCAA requirements.

DCAA Requirement:	Project Workforce Management Solution:
General	
Access to data must be controlled	Windows NT authentication and role-based security that complies with DCAA requirements for format, history, aging, and lockout after multiple failed login attempts
To substantiate costs, sufficient records must be retained three years after the final contract billing	All data is stored in a central and secure database. Internal auditors can generate real-time reports on all government contracts and overhead costs
Time and expense process includes a verifiable audit process for all changes and transaction entries	Audit of all approvals, changes, entry deletions/creation; audit reports
Time	
Every employee must record their own time charges	Users login using NT authentication or secure passwords.
Time charges must be recorded daily	Timesheets can be locked for previous days; system requires that a note be entered by the user to change any past entries
Changes to time entries require an explanation by the employee and management approval	Any change creates an audit event. Users and managers can be required to provide explanations for any modifications or corrections
If the resource is shared, the resource time charges should be split across multiple projects	Split billing
Costs	
Identify direct project costs versus overhead costs	Define types of expenses; and identify which ones are billable expenses. Provide appropriate access rights and enforce a note entry when changing data; allow billable flag override on a per entry basis.
A verifiable process for identifying why an incurred expense is a direct cost	Approval process for expense reporting and money charge entries

Conclusion

At its core, DCAA exists to assure that the government's buying agency gets its money's worth. For most contractors, that goal probably aligns completely with the overarching goal of any project a company undertakes.

Realistically, DCAA compliance is just one dimension of an issue that is much broader than government contracts. It's the need to track costs, revenue, resources and performance for all types of projects, in both private and government sectors.

The automation tools that a government contractor needs for DCAA compliance don't change for an internal R&D project or a contract with a private-sector customer. All need an empowered workforce ready to innovate, collaborate and share resources and best practices across business and geographic boundaries. All need a better way to channel the right resources to the right projects and to track the performance of those resources with management goals. All need a better way to manage skill sets, scope changes, and risks.

Tenrox Project Workforce Management is a solution with powerful capabilities to span the diverse, yet common, requirements of any project – a government contract, a private sector contract or an internal R&D project. In doing so, it gives management a control hub for total visibility and control of every project, everywhere, at all times.

For more information about DCAA compliance and the benefits Project Workforce Management can deliver for your organization, please call us directly at 1.877.483.6769 (1.877.4TENROX) or visit: www.tenrox.com.



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