



A Contractor's Guide to Incurred Cost Submissions & Audits

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Introduction

Incurred Cost Submissions (ICS) and audits present challenges for government contractors. The ICS and the corresponding audit are much more than “check the box” compliance requirements completed once a year and are typically audited many years after completion. An inadequate ICS or failure to prepare for the audit of an ICS can adversely affect a contractor’s finances and profit every bit as much as underbidding a contract or performing it poorly.

The purpose of this white paper is to provide contractors with the information required to ensure the ICS and related audit optimizes cost recovery. This white paper is divided into three parts.

1. The first part will describe the ICS process utilizing the who, when, where, what, and why format.
2. The second part will describe the government’s current approach to incurred cost audits.
3. The white paper will conclude with best practice tips based on Aprio’s decades of experience preparing incurred costs submissions for our clients and supporting incurred cost audits.

Incurred Costs Submissions

What is an ICS?

The ICS is a mechanism to balance a contractor’s actual indirect cost to the indirect costs provisionally billed in a contractor fiscal year.

The ICS consists of 15 separate schedules covering six broad areas:

1. Schedules A through E: Presentation of indirect cost pool and base components
2. Schedule H/H-1/Summary H: Presentation of direct cost by contract at the funding or billing level
3. Schedule I: Presentation of cumulative cost incurred, cumulative billing and calculation of over or under billing amount
4. Schedule K: Presentation of Times and Materials (T&M) contract costs
5. Schedule N: Certification of Final Indirect Costs
6. Schedules F, J, L, O, Supplemental Schedules: Presentation of various supplementary information including cost of money, subcontractor information, reconciliation to payroll information, contract close out data, executive compensation and other supporting information necessary for audit of the incurred cost submission

What is an adequate ICS?

The “Allowable Cost and Payment” clause requires the contractor to submit an “adequate” ICS. DCAA has developed an “Incurred Cost Submission Adequacy Checklist.” Upon submission, DCAA will use their checklist to review the ICS for adequacy. An ICS that is deemed to be inadequate will be rejected and returned to the contractor for corrections.

ADDITIONAL RESOURCE

A copy of the DCAA ICS adequacy checklist in Microsoft Word format can be found at: www.dcaa.mil/Checklists-Tools/Incurred-Cost-Submission-Adequacy-Checklist/. This checklist is used for assessing the adequacy of final direct and indirect incurred costs to ensure compliance with the contractual requirements under the Federal Acquisition Regulation (FAR).

Why Is An ICS Required?

Payments under a cost reimbursement or the “Material” part of a T&M contract are designed to reimburse the contractor for their actual allocable and allowable costs.

For the most part, the allocability and allowability of direct costs, such as labor or Other Direct Costs (ODCs), can be determined in real time, either through supporting data included with the invoice or via a paid voucher audit. For instance, contemporaneous timekeeping or payroll records can support labor charges, and vendor invoices/accounts payable records can support ODCs. A well-administered contract should have few if any direct cost issues upon conclusion.

However, indirect costs are not subject to real-time verification on an invoice by invoice basis. The actual indirect cost to be allocated to contracts cannot be determined until the contractor's fiscal year is closed and the indirect cost pools and their allocation bases are finalized.

In order to support contractor cash flow, the government allows indirect costs to be invoiced using “provisional indirect rates” based on the contractor's budget for that fiscal year. It is highly unlikely that the budget, including both the estimated pools and bases, will result in a precisely accurate allocation of the actual indirect costs.

CASE STUDY EXAMPLES

The ICS requirement combined with the incurred cost audit are designed to ensure the contractor will be reimbursed only allocable, allowable indirect costs.

In cases where the provisional indirect rates resulted in an over recovery, the contractor will be required to refund the delta.

In other cases, it may be determined the provisional indirect rates were understated, which may result in the contractor receiving an additional payment. Additional payments will be contingent on other contract terms such as indirect rate ceilings and sufficient funding.

Who Must Submit An ICS?

A final indirect cost rate proposal is required by the FAR clause 52.216-7 “Allowable Cost and Payment.” This proposal is usually referred to as an “incurred cost submission.”

This clause is required for all cost reimbursement and T&M contracts other than contracts for commercial items (e.g. GSA Schedule, FAR Part 12 contracts). Though not a mandatory flow down, many prime contractors include the clause in their cost plus or T&M subcontracts. Therefore, all cost reimbursement or T&M prime contracts and any cost reimbursement or T&M subcontracts that include FAR 52.216-7 require the contractor to submit an ICS.

SPECIAL NOTE

Though not considered an ICS, fixed price incentive contracts require the contractor to submit a “detailed statement of all costs incurred” upon contract completion, which is somewhat analogous to an ICS.

When Must The ICS Be Submitted?

Contractors subject to FAR 52.216-7 must submit an “adequate” ICS within six months of the end of each contractor fiscal year. That means for contractors with a December 31st year-end, the ICS is due by June 30th. Upon request of the contractor, along with appropriate supporting data, extensions to the due date may be granted by the Contracting Officer (CO) for exceptional circumstances.

Where Must The ICS Be Submitted?

The ICS must be submitted to the Contracting Officer (CO) or cognizant Federal agency official and to the contractor’s cognizant audit office.

Larger contractors, especially DoD contractors, are typically assigned an Administrative Contracting Officer (ACO) and a cognizant audit agency. Contractors that lack an assigned ACO should submit their ICS to the CO assigned to their largest negotiated contract. For contractors without an assigned audit agency, there is a general submission box for whatever branch the contractor is assigned to found on the DCAA’s website.

Subcontractors required to submit an ICS can submit it to:

- The prime contractor (if they don’t mind disclosing their actual rates)
- The subcontractor’s ACO and cognizant audit agency if they also have prime contracts with the requirement
- The prime contractor’s ACO and cognizant audit agency if the subcontractor doesn’t have prime contracts that require an ICS.

The Incurred Cost Audit

Will There Be An Incurred Cost Audit?

HISTORICAL CONTEXT

Per the FAR, contracts that require the settlement of indirect cost rates should be closed within 36 months of contract completion. This timeline is a laudable goal in theory but laughable in reality. Due in part to staffing shortages at DCAA and other priorities, a substantial backlog of incurred cost audits developed. In some cases, contractors had not been audited or received final indirect cost rates for over 10 years.

Under pressure from the contractors and Congress, DCAA developed a plan to alleviate the backlog. Previously, all incurred cost submissions were audited. Since 2012, incurred costs audits are now risk-based.

The chances of an incurred cost audit depends on the risk rating and auditable dollar value.

Risk rating

Incurring cost submissions deemed by DCAA to be “high-risk” will be audited. Presumably, it is obviously in a small contractor’s best interest to be classified as low-risk. While assigning a risk rating to an ICS may be more of an art than a science, DCAA will, at a minimum, consider the following factors:

- Results of previous incurred cost audits (i.e. percent of questioned costs)
- CO or auditor identified risks
- Fraud referrals
- Unacceptable accounting system or other business system reviews
- Specific relevant CO or auditor experience with the contractor
- History of submitting late or inadequate ICS

Auditable Dollar Value

Incurring cost submissions that are not automatically audited based on the above criteria will be audited per a risk rating assigned by DCAA. Incurring cost submissions deemed “low-risk” will be placed in a pool and audited based on “sampling” per the following matrix.

Low	< \$5M	
	\$5M to < \$100M	
Medium	\$100M to \$250M	Mandatory audit every 5th year
	> \$250M to \$500M	Mandatory audit every 4th year
High	> \$500M to < \$1B	Mandatory audit every other year
	\$1B or more	Audit must be performed every year

What Are The Ramifications Of An Incurred Cost Audit?

Ideally, the incurred cost audit will result in no questioned/disallowed costs. However, in Aprio’s experience a clean incurred cost audit is unlikely. Any costs questioned by the auditor will be removed from the pool(s) and the indirect rates will be re-calculated. Assuming the CO agrees with the auditor, the contractor will have to refund any “overbilled” costs within 60 days after settlement of the final indirect rates.

In addition, if the disallowed cost is expressly disallowed by the FAR Part 31 cost principles, the contractor must pay a penalty equal to the disallowed cost plus interest. If the expressly unallowable cost was claimed a second time, the penalty will be two times the disallowed cost. The application of the penalties can turn what once appeared to be a profitable year into a not-so-profitable year.

Best Practice Tips

Maintaining A Low-Risk Rating

In addition to the likelihood of questioned costs, undergoing an incurred cost audit is a resource intensive experience for a contractor

Therefore all contractors, especially ones with less than \$250 million dollars of auditable dollar value, should strive to be rated low-risk. This can be accomplished by focusing on the following:

- Consistently submitting an adequate ICS on time
- Only claiming allocable and allowable costs
- Maintaining an adequate accounting system and any other required business systems
- Minimizing invoicing or other cost-oriented disputes with the CO

Besides a high-risk rating, failure to submit a timely ICS can result in the government unilaterally determining a contractor's final indirect rates.

Previously, DCAA would send contractors a "reminder" that their ISC was due a month before the end of the contractor's fiscal year and, if necessary, another reminder if the ICS was over five month late. Now DCAA only notifies contractors if their ICS is 30 days late and copies the CO. At that point, the CO is authorized to unilaterally establish final rates, which may include a decrement of up to 16.2% (based on a 2014 Agency-wide analysis).

Preparing The ICS

Assign responsibility

Preparing an ICS or undergoing an incurred cost audit are akin to a project and, like any project, need a leader.

Contractors should assign the responsibility to prepare the ICS and support the corresponding audit to a specific employee, typically the CFO or controller. This individual must have the skills, experience, time, budget, and resources required to ensure these tasks are successfully performed.

In the alternative, the preparation of the ICS and support for the audit can be outsourced to a CPA firm with a specialty in government contracting.

Address in accounting P&PS

The processes and procedures to be followed when preparing the ICS or supporting the audit should be reduced to writing and included in the accounting policies and procedures. In addition, auditors will likely request the following policies and procedures:

- | | |
|-------------------------------------------------|-------------------------------------|
| ● Segregation of Unallowable Costs | ● Travel Policy |
| ● Bonus Policy | ● Billing Policy |
| ● Labor and Timekeeping | - Handling of Withholds |
| ● Subcontractor/Vendor Procurement and Payments | - Contract Limitations |
| | - Labor Category and Qualifications |

Use a data gathering checklist

Checklists are a godsend for government contractors. Aprio recommends that a contractor use the following checklist when preparing the ICS:

- Trial balance (in Microsoft Excel format)
- Payroll reconciliation
 - Year-end Payroll Summary Report
 - W-2 Summary
 - 941 Quarterly Tax Returns
- Statement of Indirect Expenses OR Final FY Indirect Rate Calculation
- Job/Project Summary Reports (at billing level)
 - Flexibly priced government contracts
 - Government T&M (normally GSA N/A)
- General Ledger Detail
- A/R History
- Contract revenue by contract type
- Year-end or last invoices (if contract ended prior to fiscal year) with cumulative for all flexibly priced and T&M government contracts with the applicable FAR 52.216-7 clause
- List of contract limitations for all contracts subject to ICS
- List of total hours booked by labor category for each applicable Federal Government T&M contract (usually GSA task orders N/A)
- Contract briefs all for all contracts subject to ICS

DCAA Model vs. Aprio Model

Though not required, DCAA has developed a spreadsheet contractors can use for their ICS, known as the ICE (Incurred Cost Electronic) model (pronounced “ice”). The advantage of using the DCAA ICE model versus a home-grown one is the ICE model will be in a format that DCAA understands and it will almost assuredly include all required schedules.

Aprio has developed an ICS model. Unlike the DCAA model, in which the 16 worksheets are populated in a vacuum, Aprio's model includes a series of embedded crosschecks to insure consistency from worksheet to worksheet.

Consequently, entries in one worksheet that don't tie out to entries in another worksheet will be flagged. This makes the pre-submission review easier and almost eliminates the possibility of submitting an ICS that does not reconcile. Inconsistency between the worksheets is one of the main reasons ICSs are deemed to be inadequate.

Utilize the DCAA adequacy checklist

All incurred cost submission should be reviewed prior to submission using the DCAA ICS adequacy checklist. All worksheets should tie and reconcile.

Brief your contracts

Contractors should prepare and maintain contract briefs for all awarded contracts and subcontracts. DCAA has a contract brief template or contractors can develop their own template. Not only is a contract brief helpful, if not essential, to correctly administer a contract, DCAA will require copies of the contract briefs during an incurred cost audit.

Scrub unallowable costs

Contractors should have written policies and procedures and processes in place to ensure that unallowable (certainly expressly unallowable) costs are not invoiced or claimed.

Understand the statute of limitations

The government has six years to assert a claim against a contractor measured from the date the government became aware or should have become aware of its claim.

From the perspective of incurred cost audits, the government historically interpreted this to mean six years from the date the incurred cost audit identified the claim. However, courts have now overruled the Government and the Statute of Limitations starts to toll when the contractor has submitted an adequate ICS.

In some cases, DCAA has returned an ICS to a contractor for a correction that does not affect the claimed costs and insist that the contractor sign and date a new certification. DCAA's theory is the Statue of Limitations will now start to toll on the date the revised certification was signed. Aprio advises clients to only re-sign and date the certification when the amount of costs claimed in the ICS has changed. To Aprio's knowledge, neither position has been litigated.

Preparing For The Incurred Cost Audit

Proper planning is important for any audit, but practically essential for the almost always complex incurred cost audits.

While it is true that auditors only question costs, COs disallow costs, ignoring the auditor and waiting to negotiate questioned costs with the CO is risky. COs are usually unlikely to overrule an auditor's opinion unless the CO is personally familiar or involved with the issue and agrees with the contractor's interpretation. In Aprio's view, it is easier to "win the audit" than to "win the negotiations."

Prepare supplemental information

The "Allowable Cost and Payment" clause lists 15 pieces of "supplemental information" which are not required to be submitted with the ICS but may be required during the incurred cost audit.

Not all of the supplemental information will be applicable to every incurred cost audit. For instance, not every contractor will have SEC 10-K annual reports.

A best practice is to review the list prior to the audit, determine the supplemental information likely to be required and ensure that it is organized and ready to present to the auditor in a professional fashion.

Track document requests & submissions

The contractor should develop a spreadsheet designed to log all requests for documents or information from the auditor by date and the date the requested documents or information were provided. Aprio has seen many instances where the audit proceeded in a disorganized and inefficient manner because neither the auditor nor the contractor kept track of the documents that were requested and provided.

Provide auditor with response to questioned costs

If the auditor has questioned any cost(s), the contractor will be given the opportunity to provide a rebuttal in writing, which the auditor will include in the audit report.

Though not always a fatal flaw, Aprio recommends contractors take advantage of the opportunity to include their side of the story (the correct side!) in the audit report. If not, the CO and anyone else who reads the audit report will assume it is accurate. That initial impression will make it even more difficult to convince the CO that the auditor is wrong during negotiations.

Avoid awarding (or accepting) cost-type subcontracts

Per the "Allowable Cost and Payment" clause, prime contractors are responsible for settling subcontractor amounts and rates and providing the status of subcontractor audits to the CO upon request. This requirement sounds good in theory, but most subcontractors will not disclose their proprietary rates and factors to their prime contractors.

Increasingly, DCAA is balking at auditing subcontractor ICSs. Though if the subcontractor is a large DoD contractor, it is possible the prime can piggy-back on the "sanitized" results of the government's incurred cost audit. Even then, delays in the subcontractor's audit will delay the prime contract closeout and any money that may be due the contractor.

The best practice is to avoid awarding or accepting cost-type subcontracts whenever possible.

Fixed price or labor-hour subcontracts do not require an ICS or any kind of rate "true-up." Labor-hour subcontracts that require minor other direct costs, such as travel, can include a fixed-price Contract Line Item Number (CLIN) so nothing is billed at cost. Even if there is a need to invoice actual direct costs, the subcontract can require receipts with the invoice and forbid the application of indirect rates. The "Allowable Cost and Payment" clause is inapplicable to any of these scenarios.

Another advantage to awarding these types of subcontracts is the prime will never be surprised by a large, late arriving rate variance invoice from a subcontractor. The bottom line is it's always easier to close out a contract when there are no subcontracts that need to be trued-up.

Avoid Common Mistakes

Almost any type of incurred cost could be questioned by an auditor but the most common findings involve the following areas:

Direct costs, though not typically the focus of an incurred cost audit, can also be questioned. Aprio has recently seen labor charges on a T&M contract questioned because the employees didn't have the qualifications required by the labor category description. In another instance, all costs associated with a subcontractor were questioned because the contractor could not produce evidence that advance notification was provided to the CO and consent to subcontract received.

These examples represent failures in contract administration that are frequently not discovered until years later during the incurred cost audit, when it is usually too late to correct. At a minimum, contractors should implement procedures and processes designed to ensure only qualified employees are billed on T&M contracts and that advanced notification is provided and consent obtained for subcontracts as required by FAR 52.244-1.

Contact Us

Government contracting is a challenging way to earn a living and many of the challenges are beyond the control of the contractor. Examples include robust competition, Low-Price Technically Acceptable (LPTA) margins, staffing shortages, government shutdowns, and more.

However, the ICS and the resulting audit is one challenge that is your control. Failure to submit an adequate ICS on time or to prepare for the audit is a self-inflicted wound. Hopefully, the information and tips provided in this white paper will prevent that from happening to your company!

Connect with Aprio today to start the conversation on how we can help your business navigate the ICS and audit process.



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Nicole has more than 25 years of experience helping practice leaders and C-level executives develop solutions to business challenges. She specializes in solution design, market expansion and profitable growth. Nicole is an expert in creatively developing solutions to ensure clients realize their goals. She is a champion for change management, technology adoption, leadership, innovation and problem solving.

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About Aprio

Since 1952, clients throughout the US and across more than 50 countries have trusted Aprio for guidance on how to achieve what's next. As a premier business advisory and CPA firm, Aprio delivers advisory, assurance, tax, outsourcing, staffing and private client services to build value, drive growth, manage risk and protect wealth. With proven expertise and genuine care, Aprio serves individuals and businesses, from promising startups to market leaders alike.