Recommendation 14: Incentivize contractor compliance and manage risk efficiently through robust risk assessment.

Problem

DCAA uses a simple risk assessment to prioritize workload. Because DCAA bears all oversight responsibilities regarding contractor costs and related business systems, and it will be affected by recommended oversight time limits. DCAA needs a more robust risk assessment approach.

Background

DCAA plays an important role within DoD's system of acquisition internal controls. When these controls are operating effectively and efficiently, they provide DoD reasonable assurance that contract prices and cost reimbursements are *free of material unallowable costs*. This concept, established by the COSO Internal Control Framework and incorporated into the GAO's Standards for Internal Control in the Federal Government (i.e., *Green Book*), is fully compatible with the FAR guiding principle of shifting focus from *risk avoidance* to *risk management*.[1] To accomplish the desired outcome of both the federal government's internal control framework and the FAR's Guiding Principles, DCAA must embrace a more insightful risk assessment process.

Findings

DCAA has made progress in the last 7 years to better focus the agency's resources based on risk. Currently, the agency uses Auditable Dollar Volume (ADV) as its primary risk consideration to determine which contractors' costs will be subject to oversight.[2] With the recommended expansion of the types of oversight tools available in DCAA's toolbox (see Recommendation 7), the agency will no longer need to perform full-scope financial statement-like audits as its only means to deliver information and assurance to contracting officers. The oversight agility provided by a wider variety of oversight tools necessitates a more insightful view of contractor cost risk. Although ADV is an important measure of potential risk—arguably the most important—consideration of other important risk measures will help DCAA better focus its resources on the contractors and cost areas that present meaningful risk to DoD.

Contractors whose final indirect cost rate proposals exceed DCAA's *high risk* ADV threshold (i.e., $250 million) cannot reduce their risk profile to anything less than high risk due to DCAA's limited risk assessment processes.[3] Defense contractors should have the opportunity to reduce their risk profile by demonstrating their commitment to consistent compliance through their own robust systems of internal control. This is precisely the objective of DoD's system of acquisition internal controls.

In the late 1980s, DoD and contractors worked together to create the Contractor Risk Assessment Guide (CRAG) Program with the intent of contractors implementing and monitoring systems of internal

---

[1] Performance Standards, FAR 1.102-2(c)(2).
[2] DoD, Defense Contract Audit Agency Memorandum 12-PPD-023(R), *Audit Guidance on Revised Policy and Procedures for Sampling Low-Risk Incurred Cost Proposals, dated September 6, 2012,* accessed November 20, 2017, https://www.dcaa.mil/Content/Documents/MMR/12-PPD-023.pdf.
[3] Ibid.

control to improve contract cost compliance.[4] Improved contractor internal controls ideally yield more effective government oversight. Some participating contractors still did not experience reduced oversight despite demonstrated improvements in compliance during the CRAG program,[5] although the program is no longer even active.

Conclusions

It is unclear why DoD's oversight has not changed when contractors invest in stronger systems of internal control; however, a clear path to that desired outcome is needed. With a refocused mission, oversight time limits, more tools in the oversight professional's toolbox, and more robust risk assessments, DCAA can become more effective and efficient.

DoD should implement a risk assessment approach whereby weightings are assigned to a variety of fact-based risk considerations. Risk weights, based on objective criteria aligned with low, medium, and high risk classifications, are assigned for each risk consideration. See Table 2-7 for proposed risk considerations and potential objective criteria for each risk classification.

Table 2-7. Risk Assessment Matrix

Risk Considerations	Low Risk Score = 1 *(unless otherwise noted)*	Medium Risk Score =2	High Risk Score =3 *(unless otherwise noted)*
Total Auditable Dollar Volume (ADV) *Cost reimbursable direct and indirect costs*	Less than $50m *(0 for less than $15m)*	Between $50m-250m	Over $250m *(4 for more than $500m; 5 for more than $1.0b)*
Total ADV as a % of business unit total costs	Less than 20% *(0 for less than 10%)*	Between 20%- 60%	More than 60% *(4 for more than 80%)*
Overall Government Participation in Indirect Costs *% of indirect costs allocable to cost-reimbursable contracts from indirect cost pools in which the government participates*	Less than 20%	Between 20%- 60%	More than 60%
Highest Participation among all allocable Indirect Cost Pools *% of indirect costs allocable to cost-reimbursable contracts from the indirect cost pool with the highest government participation*	Less than 20%	Between 20%- 60%	More than 60%

[4] Department of Defense, *The DoD Contractor Risk Assessment Guide (AD-A203 565)*.
[5] U.S. Congress, Office of Technology Assessment, *Building Future Security,* OTA-ISC-530, accessed December 29, 2017, https://www.ota.fas.org/reports/9205.pdf.

Risk Considerations	Low Risk Score = 1 *(unless otherwise noted)*	Medium Risk Score =2	High Risk Score =3 *(unless otherwise noted)*
Number of Final Indirect Cost Rates Applicable to Government Contracts	Less than 4	Between 4-8	More than 8
Number of Intermediate Cost Pools	Less than 4	Between 4-8	More than 8
Net Annual Indirect Cost True-up *Most-recently closed contractor fiscal year – Total true-up amount (provisionally-billed vs. proposed final) as a percent of total final proposed indirect costs*	Less than 1%	Between 1% and 3%	More than 3%
Adequacy of Final Indirect Cost Rate Proposals	All required in last 3 years	More than 50% in last 3 years	Less than 50% in last 3 years
Cost Accounting Practice Changes *Most-recently closed Fiscal Year, as reported on Schedule M; exclude organizational changes and adoption of new practices*	None	Less than 2	More than 1
Prior Fiscal Year Sustained Questioned Costs *Net impact to cost-reimbursable contracts of questioned costs agreed upon or accepted by the contracting officer*	Less than 1% or N/A	Between 1% and 3%	More than 3%
Business Unit CAS-Covered Contracts *Modified Coverage, Full Coverage, Neither, or Both*	Neither *(Small Business = 0)*	Modified coverage	Full coverage or both
Accounting System Status *Within last three contractor fiscal years*	Approved with no significant deficiencies	Approved w/ one or more significant deficiencies or not evaluated	Disapproved (i.e., one or more material weaknesses)

These recommended risk considerations provide meaningful insight into contractors' business and contract profiles, how much the government participates in indirect cost pools, the complexity of a contractors' indirect cost structure, the status of contractors' business systems, and whether contractors must comply with CAS, among other things.

The sum of all risk weightings for a particular contractor business unit (as determined by the contractor organization responsible for submitting an annual final indirect cost rate proposal), should be used to make an initial objective determination of that business unit's overall risk profile.

- *High risk* business units should be subject to the most robust oversight, which may include the broadest scope and the oversight agency's highest level of assurance. High risk contractor business units will have an overall risk score greater than 30.

- *Medium risk* business units will be subject to oversight in targeted areas (i.e., cost items that represent the most significant cost risk to the department). The agency may not need to perform oversight on all contractor cost representations if prior oversight activities demonstrate a high degree of contractor compliance. Medium risk contractor business units will have an overall risk score between 25 and 30.

- *Low risk* business units will be subject to periodic oversight pursuant to DCAA's current low risk sampling approach. Low risk contractor business units will have an overall risk score less than 25.

The table below illustrates the level of oversight for each of the above risk categories. Most small businesses would receive a low risk score, and thus receive the most-targeted and least burdensome oversight.

Table 2-8. Examples of Envisioned Oversight Levels by Risk Category

Contractor Submission	Low Risk	Medium Risk	High Risk
Final Indirect Cost Rate Proposal	May be selected for analysis on a sample basis. Analysis limited to material indirect cost accounts that may contain unallowable costs, or other procedures designed to address potential material indirect cost allocation risks	May be selected for limited-scope audit on a sample basis. Audit procedures limited to material indirect cost accounts and evaluation of cost allocation bases with over 50 percent government participation	Full-scope audit of material indirect costs, as well as the completeness and accuracy of cost allocation bases.
Forward Pricing Rate Proposal	Analyze historical trends and review of contractor explanation for material rate changes	Analyze historical trends and year-over-year variances in material indirect cost elements	Analyze historical trends, year-over-year cost variances, and evaluate bases of estimates for material cost elements and business volume

This risk assessment process will allow certain otherwise high-risk business units (in terms of ADV) to migrate into medium-risk with strong past performance and sound accounting system internal controls. Conversely, otherwise low-risk business units may migrate into medium or high risk with poor prior compliance history, poor internal controls, and overly complex cost accounting structures relative to their size. As shown in Table 2-9, 81 percent of DoD's contractors that are required to submit final indirect cost proposals have an ADV of less than $15 million and will generally receive a low risk score, and thus receive the most targeted and least burdensome oversight (see Table 2-9).

Table 2-9. CFY 2016 Incurred Cost Proposals Auditable Dollar Value (ADV) Strata[6]

ADV Strata	Contractors		Total ADV ($000)	Percent Total ADV $
$1 to $15M	2,961	81.0%	$ 9,172,162	5.8%
$15M to $100M	525	14.4%	$ 23,103,974	14.6%
> $100M	154	4.2%	$ 52,334,571	33.1%
> $1B	17	0.5%	$ 73,684,447	46.5%
Total	**3,657**	**100.0%**	**$ 158,295,154**	**100.0%**

All of the data necessary for the risk considerations exist within a contractor business unit's final indirect cost rate proposal, or are otherwise readily available. To facilitate consistent, reliable data-gathering across all contractors, a new summary schedule should be added to each required Final Indirect Cost Rate Proposal (FAR 52.216-7(d)) to assist DCAA with capturing this necessary information. DCAA should share its annual risk assessments with contractor business units, upon their request, to ensure the agency's data are accurate and to create transparency.

Implementation

Legislative Branch

- No statutory changes are required.

Executive Branch

- DoD should implement a risk assessment approach.
- In accordance with the statutory requirements of DoD and the Section 809 Panel, and as set forth in Section 803 of the FY 2018 NDAA, the Section 809 Panel will deliberate on the draft risk matrix shown in Table 2-7 and provide definitive recommendations prior to the sunset of the panel in January 2019.

Implications for Other Agencies

- There are no cross-agency implications for this recommendation.

---

[6] DCAA, emails to the Section 809 Panel staff, September8, 2017 and September 17, 2017.