

New ICP Guidance from DCAA Further Reduces the Risk of Audit

Many of our clients are receiving letters from the Defense Contract Management Agency (DCMA), i.e. their Administrative Contracting Officer (ACO) approving their indirect rates as submitted within their Incurred Cost Proposals (ICP) without having to go through an audit from the Defense Contract Audit Agency (DCAA).

How can this be? Doesn't FAR 52.216-7 and 42.705 dictate that there has to be an audit before indirect rates are approved? While a careful reading of these regulations do suggest this is the case, a Class Deviation (2012-O0013) from the Department of Defense states:

“Department of Defense contracting officers shall continue to rely on either a DCAA audit report or a DCAA memorandum documenting that, based on a risk assessment and a proposal adequacy evaluation pursuant to FAR..., DCAA deemed the incurred cost proposal to be low-risk and did not select it for further audit.”

DCAA Risk Determination Guidance

Due to growing backlog of unaudited ICPs, DCAA is continuing a risk-based approach to reducing the backlog. In their guidance memo 13-PPD-021(R) published October 29, 2013, the DCAA outlined thresholds and criteria to be applied to ICPs whereby ICPs having less than \$1 million in auditable dollar value (ADV) may not require an audit, and ICPs be-

tween \$1M and \$5M may be randomly sampled for audit at a rate of 5%. This memorandum revises the DCAA policies and procedures for sampling low-risk incurred cost proposals previously established in 2012.

ADV defined

Criteria for selecting ICPs (also called Incurred Cost Submissions – ICS) are twofold. The first is based on the auditable dollar value (ADV) of an ICP. ADV is defined as the aggregate of the total cost of all flexibly priced contracts reported in the ICP. So whereas a contractor might have done \$10M worth of work in a fiscal year, yet less than \$1M in cost-plus type government contracts, their ADV would be considered less than \$1M.

Risk Factors

After the ADV is determined for each ICP, the DCAA, according to its guidance, will evaluate the risk.

High risk factors include:

- Indications or reports of fraud
- Pre-award surveys of accounting systems deemed to be “unacceptable”
- Any other deficiencies (timekeeping, billing, penalties for unallowable costs, etc..) that may give the DCAA reason to deem a contractor as high-risk.

Low-risk factors include:

- Absence of high risk factors
- Assuming the contractor has been audited before, less than 10% of ADV has been questioned in previous audits.



What if a contractor has never audited?

The latest guidance does give a clue if a contractor has yet to face a DCAA ICP audit. According to the DCAA memo, “If a contractor has more than one incurred cost proposal and the DCAA has no prior experience with the contractor, the audit team should use professional judgment to determine the audit effort that should be performed based on the above criteria.”

Action Plan

It should be obvious, then, that operating an accounting system in a compliant manner, submitting ICPs on time, and making appropriate billing adjustments due to indirect rate performance will keep contractors out of the high risk arena. Should your ICP be selected for an audit, prior to the DCAA entrance conference or during an entrance conference, determine with the auditor if this recent guidance applies, and if it does, why you are considered a high risk. An auditor may not have all the information available to substantiate a determination of low risk. (Continued Next Page)

Research and Development Tax Credits – Are you missing out?

Many tax preparers are not aware of the significant opportunity for their R&D business clients that do contract R&D for the government, especially the Department of Defense. There is a general belief if the R&D effort is being funded by a Government agency it does not qualify for any credit. But wait, that may not be true and your tax preparer may be “short changing” (short crediting?) you by not fully understanding the rules and the opportunities.

Now the obligatory disclaimer – **The information contained in this article is not intended as tax or legal advice but is offered as information your tax preparer should consider when preparing your tax return. Each situation must be independently evaluated by a professional tax preparer.**

Internal Revenue Code (IRC) §41 Credit for Increasing Research Activities (commonly referred to as the “R&D Tax Credit”) provides for tax credits for “Qualified Research Activities”. There are two questions associated with this credit from a government contractor standpoint; 1) Is the technical effort incurred by the contractor excluded

from the definition of “funded research” (“funded research” effort does not qualify for the R&D Tax Credit), and 2) Does the technical effort satisfy the requirement for “qualified research”. If the answer to these questions is yes for certain expenditures incurred by the contractor then these expenditures will qualify for the R&D Tax Credit.

There are 2 questions in determining if the research is excluded from the definition of “funded research” (if the answer to either question is no then the research is considered to be “funded research” and does not qualify for the R&D Tax Credit):

1. **Is payment for the contractor’s research activities “contingent upon the success of the research” under Treasury Regulation section 1.41-4A(d)(2)?** This section states in part “Amounts payable under any agreement that are **contingent on the success of the research** and thus considered to be **payment for the product or result** of the research (see § 1.41-2(e)(2)) are **not treated as funding.**”(i.e. not treated as “funded research”)[*emphasis added*] In general, **one or more payments under Firm Fixed Price contracts** with the Department of Defense are **contingent on** the acceptance of deliverables which represent acceptance of the **results (or success) of the research** as determined by the technical sponsor. As such this qualifies for “not treated as funding”, and the answer to the initial question is YES. This however is, in general, **not the case for cost type contracts** where the contractor (unless specifically stated otherwise) is only obligated to work toward the Statement of Work until the funding is expended. See both FAR

52.232-20 - *Limitation of Cost* and FAR 52.232-22 - *Limitation of Funds* for further discussion on a Contractor’s responsibility when funds are depleted.

2. **Does the contractor retain “substantial rights” in the results of the research activities within the meaning of Treasury Regulation Section 1.41-4A(d)(2)?** This referenced section is captioned “*Research in which taxpayer retains no rights*”. All contracts awarded to small businesses by the federal government must include appropriate language from the Bayh-Dole Act (circa 1982). The language from this law is incorporated in Federal Acquisition Regulation (FAR) 52.227-11 Patent Rights – Ownership by Contractor, a clause required to be included in all small business contracts awarded by the federal government. This specific FAR clause provided for

SBIR Solicitations

- April 4: DoT SBIR Closes
- April 5: HHS/NIH SBIR/STTR Grants Closes
- April 9: DoD STTR 2014.A Closes.
- May 2: NIST SBIR Closes
- May 7: HHS/NIH SBIR/STTR Grants (Aids-related) Closes
- May 10: NSF SBIR Accepting Proposals (STTR on May 11)
- June 10: NSF SBIR Closes (STTR Closes on June 11)

ICP’s (continued)

If you do get a letter from the DCAA and DCMA accepting your indirect rates as final, make sure these are the rates you proposed. If you haven’t already done so, you are required to update your billing on contracts affected by the final rate determination.

Contract Closeout

For contracts where indirect rates for the final year of performance have been settled, you may also be allowed to recover any fee that was previously withheld. Contact us for a complete evaluation of any contracts requiring closeout to make sure you are billing for all that you are entitled to.

-Contributed by Dave Donley,
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Research and Development Tax Credits – Are you missing out? (continued)...

the small business contractor to “retain title to all subject inventions” resulting from the research performed as part of the contract statement of work. This clause clearly allows the contractor to retain “substantial rights” (in this case intellectual property rights which is the essence of value for all research). Accordingly the payments under all government contracts with this clause meet this test for exclusion and the answer to this question is YES.

The second question in determining if the effort qualifies for the R&D Tax Credit is – “Does the effort satisfy the requirement for “qualified research”. There are four “sub-tests” to satisfy this test for “qualified research”:

Expenditures must be expenses as determined under section 174 (the Section 174 Test),

The purpose of the effort is the discovering information which is technological in nature (the Discovering Technological Information Test),

The resulting application of which is intended to be useful in the development of a new or improved business component of the taxpayer (the Business Component Test), and

Substantially all the activities of which constitutes elements of a process of experimentation for a qualified purpose (The Process of Experimentation Test).

To satisfy the Section 174 Test the expenditures incurred by the taxpayer (remember now, this is IRS language and not Government contractor language) must be incurred in conjunction with the taxpayers trade or business and represent expenditures of an “experimental or laboratory” sense. Expenditures incurred

by contractors in performance of R&D contracts with the DOD should satisfy this test.

To satisfy the Discovering Technological Information Test the expenditures must be incurred to eliminate uncertainty concerning the development or improvement of a business component and be based on principles of physical, biological sciences, engineering or computer science. Expenditures by contractors in performance of R&D Contracts with the DOD generally are incurred to eliminate uncertainty and are based on sound principles of physical sciences and engineering.

To satisfy the Business Component Test the taxpayer must intend to use the resulting “discovery” for a new or improved “business component” (product, process or service in Government contractor language). Generally contractors intend to use the results of the technical effort to improve and advance technology for future products and services. As such contractor effort should generally pass this test.

And finally, **to satisfy the Process of Experimentation Test** the taxpayer must employ “elements of a process of experimentation” which in research science and engineering terminology means utilizing established “research methodology” in designing the tasks, tests and approaches to the effort. Most R&D contractors and the key members of the research team are trained and practiced in well-established research methodology. In general, R&D contractors being funded by Government agencies should pass this test.

CONCLUSION

The expenditures incurred in support of firm fixed price (FFP) contracts awarded to government contractors in conjunc-

tion with the Small Business Innovation Research programs, Small Business Technology Transfer programs and other Government research programs should be seriously evaluated against these criteria for R&D Tax Credits in accordance with Internal Revenue Code Section 41. Consult with your tax preparer for expert advice in this area.

*-Contributed by Russ Farmer,
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Have Questions About the DCAA and/or Government Contracting?

ReliAscent is your source for information on Accounting and Contracting Compliance. Over the last few months, we have been expanding the size of our online library of whitepapers, blogs and YouTube Videos on the DCAA and Federal Contracting Requirements and Compliance. Click the links below to check out our latest additions:

YouTube Videos

- [DCAA-Compliant Accounting Software Review](#)
- [Incurred Cost Proposals](#)
- [Outsourced Virtual Accounting \(release date: 4-3-14\)](#)

Whitepapers

- [Invoicing the Federal Government Part I](#)
- [Invoicing the Federal Government Part II](#)

Blog

We appreciate your business and comments, so feel free to contact us if you have any questions, and come back to our YouTube channel and website periodically to stay informed!