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As long-time readers know, we tend to be quick to criticize DCAA audit guidance. In our experience DCAA auditors would like to "do the right thing" in terms of audit procedures and findings, but find themselves constrained by guidance in their Contract Audit Manual (CAM), guidance in recently issued Memoranda for Regional Directors (MRDs), and by undocumented decisions made by Regional leadership (as well as by Fort Belvoir leaders). Thus, we tend to criticize the guidance as opposed to the auditors.

As we've written in several blog articles over the years, our belief is that well-trained, experienced, auditors generally have the judgment and discretion to reach their own conclusions, without the multiple layers of management review heaped upon them. Yes, we can argue as to whether your individual DCAA auditor meets the generally-accepted professional standard of "well-trained [and] experienced" but that's as much a matter of luck as anything. The acumen of an individual in any large group is going to be subject to the bell curve—and there are roughly 5,000 DCAA auditors. Of course your mileage may vary from the expected mean.

Which is why we focus on audit guidance. If the audit guidance is good, the average DCAA auditor ought to be able to execute against it and reach reasonable, supportable, conclusions. If the audit guidance is bad, then even the best auditor is going to be challenged in executing against it, and in reaching reasonable, supportable, conclusions.

Over the past four years, we haven't had many nice things to say about DCAA audit guidance. (You may have noticed that.) We believe our criticisms have been reasonable. Not everybody agrees with us or thinks we have been reasonable in our negative assessments. In our defense, when we see good guidance, we also point that out to our readership—as we have a couple of times in the past few months.

Today we have another piece of good audit guidance to bring to your attention.

It concerns how DCAA auditors should determine the allowability of the cost of outside consultants used by contractors.

We've **written about** the use of consultants before and we summarized applicable regulatory requirements in that article, as well as discussing some other compliance challenges in that area.

The allowability of consultants' costs has long been an area of contention between DCAA and contractors. In fact, consultant costs are often considered to be "low-hanging fruit" with respect to generating questioned costs—and we all know how giddy it makes Fort Belvoir to report "taxpayer savings" from such questioned costs to Congress every year. (Never mind the fact that the majority of those "questioned costs" are never sustained by a Contracting Officer, and often lead to protracted litigation that significantly costs those same taxpayers.)

(Rumor around the watercooler is that DCAA Director Fitzgerald has established an expected target of 6% CQ for each ICS audit. We have not verified that rumor. But we digress.)

In any case, DCAA recently updated applicable audit guidance via **MRD 13-PAC-026(R)** , issued December 19, 2013. Generally speaking, we like what we read. The guidance tells auditors to focus on substance, not form, and to use professional judgment to determine the allowability of consulting costs. That sounds promising, doesn't it?

The first thing we noticed about the guidance is that it is "effective immediately for all new and in-process assignments." That means that it applies to any 10100 (ICS) audit of your annual proposal to establish final billing rates, even if that audit has been exited. So long as the audit has not been issued, it is subject to the guidance—which could give you an opportunity to get some of the questioned costs associated with outside consultants reversed! (Not likely, but still ….)

Second, the guidance stated—

… we want to ensure that when testing a transaction for allowability, we apply the appropriate audit criteria (i.e., FAR Cost Principle) based on the nature of the claimed cost and not the account in which the contractor recorded the cost. In some instances, costs recorded as consultants may represent purchased labor, and audit teams should evaluate these costs using appropriate audit criteria.

In our experience, it's been tough to convince DCAA auditors that a vendor is not a consultant, especially when the associated cost has been misrecorded into the wrong General Ledger account. The foregoing should be helpful in that area, especially when you use the following—

Audit teams must first determine whether the underlying nature of the claimed cost represents professional and consultant services before applying the documentation requirement in FAR 31.205-33(f). … The audit team's assessment of the underlying nature of the claimed costs determines whether FAR 31.205-33 is applicable and not the contractor's accounting classification. For instance, contractors may record expenses for purchased labor (e.g., janitorial, clerical, security) in a "Consultant" or "Professional Services" account; this does not make these costs subject to the requirements of FAR 31.205-33. Likewise, costs recorded in other accounts may be professional and consultant service costs and the auditor should evaluate the costs using the criteria of FAR 31.205-33.

Accordingly, it couldn't be clearer that the first step in evaluating the allowability of consultant costs is to conclude that the costs are, in fact, consultant costs. And it is the *underlying nature of the activity* , and not the contractor's cost account description, that drives that determination. Only after the auditor concludes (with appropriate evidence) that the cost is related to a "professional and consultant services" (as that term is defined in the FAR Cost Principle) should the auditor then go on to evaluate the allowability of that cost using the three-pronged test of 31.205-33. If the auditor concludes that the cost is not related to "professional and consultant services" then the three-pronged test cannot be used to determine cost allowability—though of course there are lots and lots of other Cost Principles in FAR 31.2 that might be used.

The audit guidance also contained helpful clarifications regarding that three-pronged test. It described the three prongs as follows—

… it is important for the audit team to understand that the evidence required from the contractor is essentially the following:

- An agreement that explains what the consultant will be doing for the contractor;
- A copy of the bill for the actual services rendered, including sufficient evidence as to the time expended and nature of the services provided to determine what was done in exchange for the payment requested, and that the terms of the agreement were met. *This documentation does not need to be included on the actual invoice and can be supported by other evidence provided*

by the contractor ;

• Explanation of what the consultant accomplished for the fees paid–*this could be information on the invoice* , a drawing, a power point presentation, or some other evidence of the service provided.

Helpfully, the audit guidance stated—

It is important to clarify that the audit team is looking for evidence to satisfy these three areas and not a specific set of documents. Therefore, auditor judgment will be the determining factor on the type and sufficiency of evidence required to satisfy these requirements. … The contractor may provide evidence created when the contractor incurred the cost as well as evidence from a later period. … As an example of evidence from a later period, the contractor may facilitate a meeting between the consultant and the audit team to obtain documentation (oral/written) from the consultant regarding what effort they performed (i.e., third party confirmation). The audit team should consider the evidence provided by the consultant, along with other evidence obtained, to determine if the total evidence gathered is sufficient to satisfy the documentation requirements

One of the most difficult areas (in terms of audit support) is to meet the third prong of the three-prong test—i.e., to provide a work product or other evidence of work performed. Given DCAA's recent tendency to delay performing audits for years (or even a decade in some extreme cases), it's usually a challenge to come up with the work product. Given that you may be looking for support for consulting expenses some four or five years after incurrence, it's challenge enough to figure out who to talk to regarding what the consultant did, let alone to hope that same person retained evidence of work performed. Thus, it's very important to review the MRD language regarding work product, since it is more flexible that previous audit guidance has been. The new guidance stated—

The purpose of the work product requirement is for the contractor to be able to demonstrate what work the consultant actually performed (in contrast to what work is planned to be performed). Although a work product usually satisfies this requirement, other evidence also may suffice. Therefore, if the audit team has sufficient evidence demonstrating the nature and scope of the consultant work actually performed, the contractor has met the FAR 31.205-33(f)(3) requirements even if the actual work product (e.g., an attorney's advice to the contractor) is not provided. *The audit team should not insist on a work product if other evidence provided is sufficient to determine the nature and scope of the actual work performed by the consultant.*

While we are not in 100% agreement with every aspect of the audit guidance (*e.g.*, we disagree that attorney-client privilege does not act to protect the contractor from disclosure of materials to auditors), we generally think this is a very positive piece of audit guidance. Now

it’s up to our readers to educate their DCAA auditors on the newly relaxed—and reasonable—requirements it contains.