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CHAPTER 3

3-000 Audit Planning

3-001 Scope of Chapter

The DCAA Management Information System (DMIS) User Guide, available on DCAA's Intranet, is the principal reference and source of information for the overall Agency planning process. DMIS contains general information about the planning process as well as specific and detailed estimating procedures.

This chapter presents general concepts and techniques of contract audit planning. Section 1 covers planning meetings with contractors and contracting officers. Section 2 covers such fundamentals as the audit assignment, the audit program for a specific assignment, factors influencing the audit scope, the types, sources and relative quality of audit evidence, and an introduction to use of quantitative methods and information technology (IT) in contract audits. Section 3 provides guidance on briefing the contract and reporting contract provisions, which would impede contract audit or administration. Supplement 3-S20 presents areas of audit coverage desired at National Aeronautics and Space Administration (NASA) contractors.

3-100 Section 1 --- Introduction to Contract Audit Planning

3-101 – Requirements Planning

FAOs will communicate with their contractors and contracting officers during the preparation of the requirements and future plans. In planning audit effort for the upcoming year, this communication helps to identify areas of risk. This communication should include discussions related to the contractor's business systems and FAR requirements (for additional information see the DMIS User's Guide, under Planning, Other Planning Topics, Other Considerations). Document the communication in the requirements and future plan working papers.

3-102 – Annual Audit Planning Meeting

At contractor locations where significant audit effort is planned, FAOs will hold an annual audit planning meeting, generally within the first quarter of the fiscal year. Participants should include the contractor's designated representatives (e.g., controller, chief financial officer, accounting personnel), administrative contracting officers (ACOs), procurement contracting officers (PCOs) with significant contracting activity with the contractor, and appropriate regional personnel (e.g., RAM, DRD, RD). At CAC locations, invite the contractor's audit committee. At the meeting, discuss the planned audit effort, the timing of significant audits, required contractor records, required contractor support and any audit matters that may require contractor management or ACO/PCO attention. The intent of this meeting is not to change the planned audit effort but to ensure the audit effort is time-phased in an efficient and effective manner. While a general discussion of real-time testing (e.g., labor interviews, material verification) is appropriate, do not give the specific dates. Documentation of the meeting should include items such as minutes, attendee list, and power point presentation or other docu-

ments provided to the contractor to facilitate discussion. The documentation should be filed in 710.6, Coordination/Correspondence with Non-DCAA Organizations. A copy of this documentation should also be maintained in the contractor permanent files on the Q Drive/Contractor Perm Files/A-03 Contractor Presentations and Briefing.

For contractors without significant audit effort, a teleconference may be appropriate. Do not identify a contractor's audit effort as insignificant based solely on low auditable dollar volume (ADV); consider the significance of all planned audits. Annual audit planning meetings are not required for contractors with little or no planned audit effort.

3-103 Operating Plan

FAOs should keep contractors and contracting officers apprised of significant changes to their operating plan that would impact the time-phasing discussed during the annual planning meeting.

3-200 Section 2 --- Introduction to Audit Assignment Planning

3-201 Scope of Section

This section discusses the audit assignment; factors influencing the audit scope; preparation of the audit program, the types, sources, and relative quality of audit evidence; and the use of quantitative methods and IT in contract audits.

3-202 Audit Assignment

a. An audit assignment is an authorization to perform a particular phase or aspect of the contract audit responsibility at a specified contractor. It includes a summary statement of the audit objectives, identifies the person or office requesting the audit, the date required, and other pertinent information which will assist in the development of the audit plan.

b. Individual audit assignments can be FAO initiated, established based on requests from internal/external customers or a combination of the two. Typical circumstances which may lead to an audit assignment include (1) a customer request for audit; (2) established contract audit requirements; (3) a new proposal, contract, or contract change; (4) a contract termination; (5) continuous system/operation audit requirements; and (6) changes in contractor's organization, operational procedures, or accounting and estimating policies. The auditor at all levels should always be alert to identify and report any instance where in her or his judgment an audit is needed to protect the Government's interest.

c. The overall audit plan at a major contractor should normally consider requirements for completion of current year and prior year audits of incurred costs by fiscal year. Plans for the completion of incurred cost audits may group prior years' effort as single audits. Audits programmed at major and nonmajor contractors may include one or more assignments established to evaluate individual audit areas of the contractor's system(s). Each assignment should include appropriate audit programs and working papers documenting work accomplished. Each assignment should also be cross-referenced to other assignments established to evaluate individual audit areas of the contractor's system(s). This should ensure that each audit assignment file stands alone without unnecessary duplication of documentation.

d. On all assignments, if not already provided electronically, request the contractor to submit its assertion or subject matter and the supporting data in electronic media, (e.g., CD-

ROM, on-line access). The data should be in an acceptable format for processing on DCAA computers.

3-203 The Audit Program

3-203.1 Contents of the Audit Program

The major elements of an audit program include:

- Purpose and Scope – describes the overall purpose and scope of the audit
- References – provides references to key audit guidance
- Audit Planning Considerations – describes the key considerations when planning the audit
- Preliminary Audit Steps – includes steps to assess adequacy of the contractor’s submission (if any), obtain familiarity with the submission or audit area, assess and summarize risk (including the assessment of the contractor’s internal controls) to establish the specific audit objectives, and to accomplish the entrance conference
- Detailed Audit Steps (Field Work) – includes tailored audit steps based on risk and the specific audit objectives to gather and analyze evidence to serve as a basis for the audit opinion
- Concluding Audit Steps – includes steps to summarize the results of the audit, prepare the audit report, conduct and document the exit conference, update the permanent files, and other concluding steps as necessary

3-203.2 Developing the Programmed Hours – Zero-Based Budgeting (ZBB)

a. Government auditing standards require that “The work is to be properly planned, and auditors should consider materiality, among other matters, in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures.” The audit program is the key to documenting the audit planning and audit procedures to be performed. It is a written plan for orderly accomplishment of the audit assignment and, when completed, is a permanent record of the work done. It reflects a mutual understanding between the auditor and supervisor on the scope required to meet government auditing standards and objectives for the assignment.

b. The audit program, as initially prepared, indicates the steps to be performed and the estimated time to complete each group of steps at the lead working paper level. For assignments with estimates in excess of 40 hours, all ZBB techniques must be used. Under ZBB:

(1) the supervisor initially provides the assignment to the auditor without a budget and instructs the auditor to perform a risk assessment, develop/tailor the audit program based on the audit scope, and estimate the budgeted hours by major audit step;

(2) the completed risk assessment and audit program are then submitted for supervisory review and approval prior to starting the fieldwork;

(3) the auditor and supervisor should discuss the risk assessment and attempt to reach consensus on the audit program/scope and budgeted hours for the assignment (if consensus cannot be reached, the process for resolving differences of opinion on audit issues provided in CAM 4-409 should be followed to resolve the difference of opinion on the appropriate audit program/scope and budgeted hours for the assignment); and

(4) fieldwork normally should not begin until the audit program is approved to ensure that no misdirected or unnecessary effort is expended. However, if the auditor is unable to obtain supervisory approval prior to beginning the fieldwork, that approval should be obtained as soon as practicable.

c. Supervisors have the flexibility to not apply all ZBB techniques on limited complexity assignments of 40 hours or less. In these circumstances, the supervisor's initial guidance would provide the auditor with an initial budget and instruct the auditor to first complete the risk assessment, adjust the audit scope and the initial budget for any identified risk, and then perform the audit. Depending on the circumstances (e.g., contractor, type of assignment, and experience of the auditor assigned), the supervisor would review and approve the risk assessment either prior to the auditor initiating any fieldwork, during an interim review, or as part of the final review process. The initial supervisory guidance should be documented in W/P A in accordance with 4-403f.(1).

d. Supervisors and auditors should use caution when setting up budgets for assignments. Audit budgets should be based upon risk factors identified in the risk assessment and throughout the course of the audit including appropriate risk factors based upon historical experience with the contractor. However, the audit risk, scope and budget should not be based upon the programmed hours nor productivity measures because neither consider current facts and circumstances applicable to the specific audit. Programmed hours are generally based upon historical experience and are to be used as a staffing tool. Further, performance measures apply at the macro level, an average of the aggregate of assignments, and not to the micro level, that is, to individual assignments.

e. The audit program provides for recording actual time, working paper reference, date completed and by whom, evidence of supervisory review and the date, and an explanation of any work not completed as initially planned, also at the lead working paper level. As a rule of thumb, budgeted and actual hours below the lead working paper level need not be separately accounted for. However, auditors and supervisors may choose to budget and account for audit hours at a greater level of detail by editing the audit program to insert the hours, by annotating the supervisory instructions, or by any other available procedure which communicates the planner's intentions. In any case, there should rarely be a need to budget and record time in increments of less than eight hours.

f. Milestone plans are required for audits of all high risk proposals, major contractor incurred costs submissions, business systems audits and other audits deemed significant by the FAO manager/supervisor and will assist in zero based budgeting. A well-developed milestone plan will include detailed audit tasks, team roles and responsibilities, and a realistic completion date for each milestone (consideration for auditor experience, annual leave, training, budgeted hours and other assignments should be factored in). The audit team will develop the milestone plan. The supervisory auditor will review the milestone plan and discuss any concerns with the audit team. The entire audit team, including the supervisory auditor, should agree to the final milestone plan. Auditors should share portions of the milestone plan with the contracting officer and the contractor. For example, auditors should discuss with the contractor the planned dates for testing, when data is needed to support the testing, and when we plan to provide them our draft report and will require a response to our findings, if applicable. Additionally, auditors should discuss with the contracting officer the need for technical reviews, including the necessary review dates, and the date we will provide our draft and final reports to them.

3-203.3 Developing the Audit Program Steps

a. Agency electronic working papers (APPS) should be used for all audit assignments. Auditors should ensure they begin the audit with the most current version of the APPS. The standard audit program included in the electronic working papers should be tailored (i.e., audit steps should be added, lined out, or modified, as appropriate) based on the documented risk assessment and the specific audit objectives. Unnecessary standard audit program steps must be lined out using the strike through option in Word. Prior to submitting for supervisory approval, the auditor will add an explanation why the step is unnecessary directly below the lined out step and include "Not Applicable" (NA) in the working paper reference column or provide an explanation on a separate working paper and include a reference in the working paper reference column. If a standard audit program does not exist for the audit area, develop a program based on the risk and audit objectives. When a tailored audit program is developed for recurring use, a copy of the tailored program should be placed in the permanent file.

APPS generates standard audit programs and sections which are not always relevant to every audit. As an example, under the 21000 Price Proposal Activity Code, there are multiple E-1 working paper sections to choose from depending on whether the labor rates have been established by Forward Pricing Rate Agreement (FPRA), have been audited but not negotiated, or have not been audited at all. Another example is under the major incurred cost audit program where a working paper section is delivered for direct material, but the contractor may not have any material costs. Under these types of circumstances, it is not necessary to include the section(s) of the audit program which are not applicable and line out the individual audit program steps and provide an explanation as discussed above. Instead, during the risk assessment phase of the audit, the auditor will document the sections that are necessary to gather sufficient appropriate audit evidence and those that can be removed as duplicative or related to areas that are immaterial. The supervisor will review the risk assessment, and approve if he or she agrees with the sections to be deleted.

b. The steps of the audit program will be integrated into the relevant working paper sections where the audit work will be performed. The audit program would typically be broken out as described below:

- Working Paper A - Summary Working Paper and Audit Planning Document - includes purpose and scope of audit and concluding audit steps
- Working Paper B - Risk Assessment and Preliminary Audit Steps - includes audit planning considerations, preliminary audit steps, and steps needed to assess risk
- Lead Working Papers - include the applicable detailed audit program steps for the cost element/area being evaluated in that section of the working papers
- Detailed Working Papers - would not typically contain any audit program steps, but provide evidence of the accomplishment of the audit program steps in the lead working papers

Refer to 4-403 for further information on working paper format and contents.

3-203.4 Modifications to the Audit Program

a. During the audit, the auditor may identify conditions that require the initial audit program to be modified (e.g., steps need to be added, are determined no longer neces-

sary, or existing steps need to be modified). When changes to the approved audit program are necessary, the auditor should discuss the need to modify the audit program with the supervisor, document the results of the discussion in the interim supervisory guidance section of the working papers (A-02), and modify the audit program based on the interim discussion. If it is determined that a step is no longer necessary, the audit program should be modified using the strikethrough function, and an explanation added directly below the lined out step or in a separate working paper as necessary. When revisions are made to the audit program, the auditor should initial and date the changes to the approved audit program. If the modification to the audit program is a result of a significant change to the initial risk assessment, the risk assessment should be updated in accordance with the guidance in 4-403f(1). If the Agency significantly revises the standard audit programs, Headquarters will post a revision notice on the Revision Notices Intranet page. If any of these revisions are so significant that they must be incorporated into audits in process, the auditor assigned will be notified via email from Policy Publications and Systems Division (PPS).

b. During the audit, reference each audit step to the working paper(s) where the step was accomplished or NA if the audit program step was determined unnecessary. Also record the actual hours expended on each step or group of steps (in the same increments as the budgeted hours).

c. On completion of the assignment, make sure that all steps in the originally approved audit program are referenced to working papers or include an explanation for why they were not done. Also make sure that the total actual hours recorded in the audit program agree with the time reported in the DCAA management information system (DMIS).

3-204 Factors Influencing the Audit Scope

The auditor is expected to exercise professional judgment, considering vulnerability and risk, in determining the audit scope. Several factors which may influence the audit scope are discussed in subsections 3-204.1 through 3-204.19 below.

3-204.1 Audit Objective

a. The purpose of the audit, or audit objective, will often determine the extent of testing as well as the steps required to accomplish the objective. The objective may range from only gathering specific data to expressing an opinion on the contractor's entire operations. Accordingly, the audit scope may be limited to gathering data or expanded to a comprehensive audit of several functions within the contractor's operations. Additionally, the scope may change depending on what the auditor finds during the audit. Regardless, the audit scope must be sufficient to develop an informed opinion on the audit objective that will satisfy the needs of the potential users of the audit findings.

b. The needs of the potential user should be identified in the request for audit and should be considered in defining the audit objective and resulting audit scope. If the requestor identifies specific areas of concern, include audit steps which will develop information to answer those concerns. If the specific concerns cannot be answered during the audit, immediately notify the requestor. If the necessary steps are beyond the auditor's expertise or ability or require significantly more than normal audit effort for

the type of audit planned, coordinate with the requestor to either clarify the request and its impact on the audit or suggest alternative sources for the needed information (such as a technical evaluation). See 4-104 for guidance on coordinating and communicating with our audit customer.

3-204.2 Type of Audit

The type of audit will affect the degree of risk to the Government and resulting audit scope. For example, in a price proposal audit, a proposed cost-type contract will generally involve a low risk of overstatement because the contractor will be paid its incurred costs under the contract as long as they are allowable, allocable, and reasonable. One risk is that the costs are understated in the proposal (as in the case of a buy-in). However, in an incurred cost or systems audit, a cost-type contract will generally involve a high risk of overstatement for the same reasons.

3-204.3 Audit Experience

When developing the audit scope, review the permanent file (including assessments of internal control system and control risk summarized on the internal control assessment planning summary sheets or internal control questionnaires, and audit lead sheets) and prior audit work packages to determine what data are available, what audit steps were done in the past, and the findings from those steps. This may identify areas where additional audit work is advisable (i.e., areas of high risk) or where audit scope can be reduced (i.e., areas of low risk).

3-204.4 Known Deficiencies

A review of prior audits may disclose known deficiencies. All such deficiencies must be considered when preparing the audit program, paying particular attention to those which have potential impact on the audit area. Include sufficient audit steps to determine whether the deficiencies still exist (i.e., the contractor may not have taken any corrective actions or may have taken actions which did not adequately correct the deficiencies) as well as determine the impact of the deficiencies on the audit results.

3-204.5 Direct Costs

Since direct costs are the basis of the indirect allocation, direct costs are more significant than indirect costs.

3-204.6 Extent of Government Business

a. When the dollar value of the Government's interest in the contractor's operation is significant, evaluation of management controls and decisions affecting the economy and efficiency of the contractor's operations takes on added importance. The audit scope should include an evaluation of the considerations which motivate a contractor to choose one course of action over others to achieve a cost objective, and the means by which all management echelons control both direct and indirect cost levels. When the

total costs charged to Government contracts are not significant, the audit effort need not be as comprehensive in the area of management controls and may be directed more toward the selection of specific cost elements, based on significance and sensitivity, for analysis to determine the costs' acceptability.

b. When the preponderance of the contractor's costs is recovered through Government cost-reimbursement type contracts and fixed-price contracts which provide for price adjustment, give particular attention to the effectiveness of management cost control. Cost-plus-fixed-fee contracts do not provide the contractor with a direct incentive to minimize costs. Similarly, redeterminable fixed-price contracts do not provide a strong incentive to maintain contract costs below the ceiling price except for incentive sharing provisions. On the other hand, when the bulk of the contractor's work consists of commercial business and firm-fixed-price Government contracts, competition and the desire to maximize profit, influence the contractor toward instituting prudent business decisions and practices to minimize costs. When cost-reimbursement and fixed-price contracts awarded to the contractor include incentive clauses, the auditor can place more reliance on the profit motive to encourage proper management control over costs. However, the extent of the audit effort in each situation should be sufficient to enable the auditor to determine the reasonableness of the contractor's policies, procedures, and practices influencing costs to assure they maximize economy and efficiency of operations.

c. Also to be considered is the mix of the above contract types in the contractor's business. A preponderance of one type or similar types will generally reduce the risk of mischarging or misallocating costs between contracts. Conversely, a variety of contract types increases the risk of mischarging or misallocation of costs, usually to the cost/redeterminable contracts from the fixed-price/commercial contracts. Therefore, the audit scope must be adjusted accordingly.

3-204.7 Organizational and Capital Structure

a. The contractor's capital structure also can affect the audit scope. When its working capital is insufficient to support its daily operations or there is a cash flow problem, the risk increases for the mischarging or misallocation of costs to those contracts which have interim financing provisions.

b. Similar problems may arise as a result of the contractor's business cycle. If its normal business is extremely cyclical, there may be a tendency to mischarge or misallocate costs to its Government contracts to help it through the low portion of the cycle. Therefore, sufficient testing of transactions must be done to assure that such actions are not occurring.

3-204.8 Similarity of Product

When the end items produced for the contract under audit are similar to end items produced commercially or for other Government contracts, place audit emphasis on the equity and consistency with which the contractor identifies direct costs with the various contracts and products. When the work performed under a Government contract differs substantially from other production, place audit emphasis on the consistency of direct charging and the use of proper bases to allocate indirect costs.

3-204.9 Indirect Cost Allocation Bases

The contractor's selection of bases for the allocation of indirect costs may have a substantial effect on contract costs.

3-204.10 Contract Financial Management

Contract financial management relates to the overall financial controls maintained by the contractor on individual contracts. It ties to the detailed controls maintained by the contractor at the various management levels and assures that timely data are generated to disclose, among other factors, when estimated costs at completion will be substantially greater or less than the contract price. In this manner, both the contractor and the Government would be in a position to adequately consider available management alternatives and make informed decisions concerning:

- (1) whether additional funds are available and will be used on the contract,
- (2) the possible availability of funds on the existing contract for reprogramming to other projects, and
- (3) the feasibility of adjusting the requirements under the existing contract through changes in the scope of work or technical trade-offs.

The audit scope should include steps to evaluate the adequacy of the contractor's financial management systems. Further guidance on this area is in Chapter 11.

3-204.11 Adequacy and Complexity of the Contractor's Systems, Policies, Procedures, and Internal Controls

a. The adequacy of the contractor's internal control structure is an important factor in determining the audit scope. Adequate controls, sound policies, and the effective implementation of prescribed policies and procedures contribute to the reliance that the auditor can place on the contractor's cost representations, and permit reduction of the extent of verification which might otherwise be required. See Chapter 5 for guidance on the audit of contractor systems of internal controls.

b. More formalized systems, such as the accounting, estimating, and purchasing, with strong self-controls built into those systems can reduce the audit effort required to satisfy the audit objective once the system has been evaluated and determined to be adequate. Poorly defined or nonexistent systems, or those which rely on external controls only, increase the risk for cost mischarging or misallocation and should correspondingly result in an increase to the audit scope.

c. Additionally, the internal control structure may affect the audit scope. If there is little separation of duties and responsibilities or if the separation is not conducive to adequate internal controls, there is greater risk for costs to be mischarged or misallocated. The control environment may be such that the same management has responsibility for and control over multiple contracts and can manipulate the allocation of costs to those contracts to the Government's detriment. Also, if the internal control structure changes frequently, the audit scope must be expanded to assure that the change(s) have not adversely affected contract costs.

- d. When evaluating the contractor's internal control systems, auditors should consider;
- (1) the amount of systems testing previously performed or currently planned by other Government agencies or independent reviewers, such as public accounting firms; and
 - (2) contractor self-governance programs.

3-204.12 Degree of Technology and Automation

The degree of technology and automation used by the contractor in its operations can affect the audit scope also (see 4-500 for use of IT in contract auditing). Generally, the more sophisticated the contractor's technology and automation, the greater will be the reliability of the resulting data. However, the reliance cannot be blind; greater sophistication also can open doors to greater risks for mischarging or misallocating costs through multiple transactions hiding the results "in the computer." Generally, the audit trail becomes less distinct as the contractor's systems become more advanced. Therefore, the auditor must consider the results of prior audits, if any, of these sophisticated systems in determining the audit scope.

3-204.13 Types and Flow of Transactions

The types of transactions which the contractor processes through its systems obviously affect contract costs. They also affect the audit scope. When transactions are generated externally, such as materials and outside services purchases, the audit scope is often limited to verification to supporting records for the transactions. There is usually documentary evidence created by an "arm's length" party that substantiates the claimed costs. When the transactions are generated internally, as with labor costs or cost transfers, the audit scope is usually more extensive. Not only are the supporting records verified, but the entire system for cost incurrence, identification to cost objectives, authorization and approval, control, monitoring, and allocation must be evaluated to ensure the validity of the costs. Additionally, the flow of the transactions through the system must be considered. If a transaction flows through any level responsible for cost control, there is increased risk of cost misallocation.

3-204.14 Types, Sources, and Relative Quality of Audit Evidence

a. The quality of available evidential matter will influence the audit scope. Evidential matter, in contract auditing, is all or any part of the body of evidence (records, data, observations, or any other information) which underlie or support a contractor's cost representations, or other area subject to audit such as Disclosure Statements and CAS Compliance. Certain types of evidence have more significance than others; thus, a small quantity of high quality evidence may be a more acceptable basis on which to form an opinion than a large quantity of lesser quality evidence. To determine the quantity of evidence required, the auditor must evaluate the quality of the types of evidence available. A single type of evidence evaluated by itself may establish an inference, but the acceptability of the evidence is greatly increased by interrelating and reconciling several kinds of evidence. The following guidelines are useful in judging the relative quality of evidence:

(1) Evidence obtained from an independent source is more reliable than that secured from the contractor.

(2) Evidence developed under a good internal control structure is more reliable than that obtained where such control is weak or unsatisfactory.

(3) Evidence obtained through physical examination, observation, computation, and inspection is more reliable than evidence obtained indirectly.

(4) Original documents are more reliable than copies.

b. For example, a controller's written statement explaining how costs are allocated to contracts by a computer program is not sufficient by itself, to use as the basis for an opinion on the reliability of the generated costs. This is the poorest quality evidence, since it is testimonial and is generated by the contractor. A written manual, even if prepared by an outside computer programmer, documenting the program's operation also alone is not sufficient. While it is better quality evidence since it was prepared by an independent source, it is still not sufficient alone to satisfy the audit objective; however, it may be used as corroborative evidence with the controller's statement. But even the two together are not sufficient evidence to base an opinion on the costs. Testing of several transactions processed through the program are necessary to assure that costs are being allocated as they should. The testing alone may be sufficient (i.e., relatively better quality evidence since it is directly obtained), but also may require further evidence to develop an opinion. These tests combined with the other two pieces of evidence may be sufficient on which to base an opinion.

c. Audit Evidence Developed by the Contractor. This includes:

(1) accounting and statistical records and supporting documentation, including minutes of the board of directors and other management meetings, collateral memorandums and documents incidental to and supporting the recorded or anticipated transactions, budgets, management records and reports, and tax returns; and

(2) formal or informal statements of policies and procedures relating to the contractor's accounting, management, and operations. The quality of the contractor-developed evidence is dependent in part on the adequacy of the contractor's internal control structure.

d. Auditor-Developed Evidence. Auditor-developed evidence includes information obtained orally, by examination of books, records, files, and/or statistical data, and by physical observation. This type of evidence also includes direct confirmations with third parties (e.g., verification of vendor quotes directly with the vendor).

e. Contractor Ledgers and Journals as Evidence. To express an opinion on the contractor's representations of incurred costs, the auditor should have evidence that the:

(1) costs claimed are supported by entries in the ledger accounts,

(2) account totals correctly summarize the detailed entries, and

(3) entries in the accounts represent a proper accounting interpretation of transactions.

The chain of evidence extends from documents describing individual transactions through the books of original entry to ledger accounts and to the cost representations. The reliability of ledgers and accounts as evidence is dependent on the soundness of the principles and policies upon which the records were developed and on the adequacy of internal controls exercised in the preparation and review of the records. Auditors should constantly be alert for potential manipulation of contractor ledgers and accounts. One example would be the removal of pages containing transactions that management or others do not want the auditor to review from a computer listing. If such a listing includes many transactions, it

would be difficult to manually verify the accuracy of the totals at the end of the listing. The use of sampling procedures described in the Variable and Attribute Sampling Guidebooks located on the DCAA intranet can provide reasonable assurance of detecting material misstatements or fraud.

f. Documents as Evidence. The review of documents is an important step in developing audit evidence. In evaluating a document as evidence, the auditor should consider the source of the document and the controls used in its preparation and processing.

g. Physical Observations as Evidence.

(1) Physical observation is the actual observance of the work being performed, the physical inspection of facilities such as the buildings and machinery, and the counting of certain assets such as inventory items. The results of physical observation usually are considered good quality evidence.

(2) Among the objectives of physical observation are (a) to ascertain the physical existence of a particular item(s), (b) to inspect an item(s) to determine whether it is being used for the purpose for which it was obtained and the extent of its use, and (c) to assist the auditor in determining the extent of testing and verification necessary to arrive at an opinion regarding the allowability of costs generated by the area being audited.

(3) Physical observation may disclose idleness of facilities or personnel and uneconomical and inefficient operating methods. Actual observation is the best evidence of the physical existence of an item, but observation alone is not conclusive as to the reasonableness, allocability, or allowability of the related costs.

(4) Plant or functional observations, including inventory observations, employee interviews, floor checks, perambulations, purchases verification, and similar techniques of physical observation are integral parts of an audit and are applicable in the audit of costs, evaluations of proposals, and the audit of terminated contracts.

(a) Plant or Functional Observations. This term usually applies to the visual appraisal of functions in a contractor's offices, plant, and other work areas and is accomplished by on-site review of practices. The objectives of these observations are to (i) relate actual practices to prescribed procedures, (ii) ascertain the degree of internal control exercised during the actual performance of the function, (iii) assist in determining the extent of reliance that can be placed on the results generated by the function, and (iv) determine the degree to which the function contributes to the economy and efficiency of the contractor's operations as a whole. Well-planned plant or functional observations are important steps in carrying out the auditor's responsibility for designing tests and procedures which will detect fraud. Unannounced physical observations should be programmed as an integral part of the audit. The auditor should be alert for evidence of fraud, waste, or mismanagement (see 4-803). This technique is especially useful in audits of receiving, production, material control, and engineering areas. (Also see 6-310, 6-312, 6-405, and 6-608.2.) Record the details and conclusions of the observations in the working papers and promptly compare them with the related accounting records. Specific guidelines for each of the major cost elements are contained in Chapter 6.

(b) Employee Interviews and Floor Checks. This term usually applies to the physical verification of labor charges. Specific guidelines for performing employee interviews and floor checks are in 6-400.

(c) Perambulation. This term usually applies to an informal type of plant observation which affords a good opportunity to uncover inefficient and uneconomical practices that might otherwise go unnoticed. It permits the auditor to observe activities and note

anything that is unusual. Planning for perambulation requires a determination as to the frequency and geographical area of coverage, but does not contemplate specific objectives. For example, the auditor may observe a major plant rearrangement of which he/she was previously unaware. The auditor should make further inquiries and ascertain the circumstances leading to the plant rearrangement and determine its effect on Government contracts.

(d) Tour of the Manufacturing Floor. This term applies to a type of plant observation which affords a good opportunity to view manufacturing processes and practices on a periodic basis to develop a better understanding of the processes and monitor trends in manufacturing processes and practices. Some contractors have established substantial technological advancements on the factory floor, causing changes in the processes and the machinery by which they manufacture their products. These changes in manufacturing operations can cause changes to the flow of costs, raising the question as to whether the contractor's cost allocation practices continue to provide equitable distribution of costs to final cost objectives. As a result auditors need to enhance their awareness and understanding of the implications of technical changes on the factory floor. Auditors should tour the contractor's manufacturing facilities periodically (several times a year) to view the machinery and manufacturing practices currently in use. If possible, have the contractor participate in at least one tour a year to explain both its current practices and the evolving changes. This will aid the auditor in developing a better understanding of the manufacturing process and in developing a baseline to determine if the contractor has changed its manufacturing methods.

(e) Purchases Verification. This term usually applies to the physical verification of purchased materials and services. Specific guidance for performing purchases verification is in 6-305.

h. Comparisons and Ratios.

(1) Comparing the amount of an expense for the current period with the corresponding amount for the preceding periods develops corroborative evidence. A comparison of costs by element can provide an overview, an order-of-magnitude frame of reference for direction of audit effort, and other audit planning/performance considerations. For example, assume that certain individual expense elements for prior fiscal periods were determined to be reasonable and acceptable; if the expenses of the current fiscal period compare favorably with those for prior fiscal periods, and if the level of operations and other factors are comparable, such a condition could be considered as a basis on which to form an opinion as to the reasonableness of current expenses. On the other hand, if comparison indicates that a particular expense element had been maintained at a relatively steady level over an extended period, but increased significantly in the current period without any apparent increase in the production volume or an offsetting decrease in another related cost element, it would indicate that further audit effort is necessary to prove the validity of the current costs.

(2) In addition to comparing the same cost elements between periods, the auditor should also consider the correlation of cost items with appropriate bases.

i. Oral Evidence.

(1) Generally, oral evidence is useful in disclosing situations that may require examination or may corroborate other types of evidence already obtained by the auditor. Oral evidence can determine audit direction and, when appropriate, should be recorded and made part of the audit file.

(2) Do not rely on this type of evidence to completely support an audit conclusion or opinion; use other confirming evidence, particularly where the matter is significant.

j. Other Sources of Evidence. Industry statistics, Government and independent studies and publications, and other sources of audit evidence may be available as indicated by the nature of the specific assignment and the auditor's resourcefulness (see 4-1003).

3-204.15 Planning in Connection with Cost Accounting Standards

Audits performed in connection with the contractor's disclosure statement and compliance with CAS (see Chapter 8) can be extremely useful in establishing the audit scope of other assignments by providing improved visibility into the contractor's organizational cost structure, the relationship between direct and indirect costs, and other cost accounting policies, procedures, and practices. DMIS CAS Compliance Testing Reports included in the permanent files provides an overview of the status of a contractor's compliance with CAS and helps identify specific areas needing consideration.

3-204.16 Mandatory Annual Audit Requirements (MAARs) Accomplishment

A general discussion of MAARs appears in 6-105; a tabulation of the MAARs, which includes title, objectives, purpose, and principle CAM reference, appears in 6-1S1.

a. Many MAARs require transaction testing and other auditing procedures that are most likely to be covered in historical audit assignments. The scope of such evaluations is affected by the strength of the controls in the area and how current the audit is. Controls affecting each of these MAARs are evaluated in at least one of the internal control areas mentioned in Chapter 5. It is often possible to reduce the scope of a mandatory audit when controls in the area are strong, or to expand the scope of any audit for the purpose of resolving other vulnerabilities identified through risk assessment procedures.

b. Procedures associated with updating the permanent file and with reconciliation of contractor data may be budgeted and accomplished as a part of the control or summary assignment for the audit. Updating the permanent file is generally performed as part of routine audit assignments.

c. The evaluation of the contractor's financial statements, corporate minutes, tax returns (see 3-2S2), reports filed with regulatory bodies, such as the Securities and Exchange Commission (SEC) (see 3-2S1), and data available on the corporate web site, if any, will assist the auditor in planning the audit more effectively. MAAR 4 requires the auditor to evaluate applicable tax returns and financial statements, including the statements of cash flow, and other publicly available data of the contractor, on an annual basis. Government auditing standards place different relative weights on various types of evidence. Greater weight should be placed on corporate reports to regulatory bodies and Federal tax returns because of the potential for severe penalties for noncompliance with reporting requirements. Further discussion of the relative quality of audit evidence is contained in 2-300 and 3-204.14.

3-204.17 Use of Quantitative Methods and IT in Contract Audits

Make optimum use of all audit techniques which will increase the efficiency and effectiveness of the audit effort. These include the use of statistical sampling, the use of

improvement curves and techniques, and the evaluation of costs and accounting systems making use of information technology (IT) equipment. Suggestions for applying these techniques to various audit situations are provided throughout the manual.

a. Statistical Sampling. DCAA policy on the use of statistical sampling is in 4-600.

b. Information technology (IT). Because of the ever increasing use of electronic data processing equipment, the auditor must become knowledgeable in the operations of such systems. Develop the audit program with due consideration to the part that IT equipment contributes to the contractor's overall accounting system. Guidance is provided in the Information Systems (IS) Auditing Knowledge Base available on DCAA's Intranet. Similarly, in conducting the audit, make full use of DCAA's APPS software (word processing, spreadsheet analysis, and database management). Guidance is provided in 4-500.

c. Use of Graphic and Computational Analysis Techniques.

Wherever appropriate, auditors should make full use of graphic and computational analysis techniques (Graphic & Regression Analysis Guidebook). The Guidebook suggests instances where the auditor could productively use these techniques.

The use of graphic and computational analysis techniques can help in incurred cost audits as well as future cost estimates and is encouraged. These techniques might, for example, provide a basis for the traditional audit selectivity in reviewing accounts or cost items. That is, the auditor may detect trends or correlations which permit her or him to focus attention on indirect expense accounts or other costs being audited which appear to be unreasonable or out of line. However, the use of these techniques in the audit of incurred cost does not lessen the auditor's responsibility to obtain pertinent evidential matter, as in 3-204.14 and to accomplish appropriate testing and verification of such data.

d. Improvement Curve Techniques.

An understanding by the auditor of improvement (learning) curve techniques (see EZ-Quant) is essential, particularly in the evaluation of projected costs. Situations where these techniques are to be used are discussed in Chapter 9, as well as in Chapter 12 where the evaluation of a reasonable profit or loss under a terminated contract is discussed.

3-204.18 RFP/RFQ and Contract Provisions

Review of contract provisions may indicate areas of audit emphasis. For instance contracts with both fixed price and cost type provisions may require additional emphasis in floor check or other direct cost reviews. See 3-300 for further guidance on reviewing RFP/RFQ and contract provisions.

3-204.19 Assessment of Internal Controls at Service Organizations

a. A service organization is an entity (or in some cases, the segment of an entity) that provides financial services to the user organization (affects the user organization's financial data). While performing a risk assessment for incurred cost or systems audits, the auditor should determine if a contractor (user organization) uses any service organizations, and if so, whether or not there is a need to gain an understanding of the service organization's controls. There is a need to gain this understanding only if:

- transactions processed by the service organization are material, and

- the service organization is part of the user organization's information system, and
- the degree of interaction between the service organization and the user organization is low. The degree of interaction is low if the service organization exercises independent judgment in initiating, processing, or reporting transactions without prior authorization of each transaction by the user organization.

b. To obtain this understanding, the auditor should review the service agreement (contract) and the service auditor's report (if any). If necessary, other information available at the user organization should be reviewed, including user manuals, system descriptions, technical manuals, other policies and procedures, and any reports prepared by the user or service organization's internal auditors relating to internal controls over transactions and processes. Also, if necessary, and with appropriate permission, the user auditor may visit the service organization and perform procedures or request an assist audit. The auditor should summarize the effects of this review on the scope of audit.

3-204.20 Contractors Use of Scanned Images

a. FAR 4.703(c) allows contractors to duplicate and store original records in electronic form. Contractors are not required to maintain or produce original records during an audit if the contractor provides photographic or electronic images of the original records and the contractor meets the requirements of FAR 4.703(c) as follows:

(1) The contractor has established procedures to ensure that the imaging process preserves accurate images of the original records, including signatures and other written or graphic images, and that the imaging process is reliable and secure so as to maintain the integrity of the records;

(2) The contractor maintains an effective indexing system to permit timely and convenient access to the imaged records; and

(3) The contractor retains the original records for a minimum of one year after imaging to permit periodic validation of the imaging systems.

b. FAR 4.703(d) allows contractors to transfer images from one reliable computer medium to another if the transfer process maintains the integrity, reliability, and security of the original data and an audit trail is retained.

c. FAOs should test the contractor's scanned images annually as part of an ongoing audit being performed at the contractor (e.g., incurred cost, proposal audit, etc.). The testing should cover the previous 12-month period. Testing of scanned images should be performed at all contractors with over \$100M Auditable Dollar Value (ADV) and select contractors with ADV below \$100M based on a risk assessment documented in the FAO's permanent file under Section B-04, Audit Planning – Audit History. Examples of factors to consider when determining if these procedures should be applied include the amount of firm-fixed-price work, the contractor's assessment as high risk for incurred cost sampling purposes, and whether the contractor typically provides scanned images as supporting documentation.

d. The procedures performed during the testing of scanned images are intended to provide reasonable assurance that we can rely on the scanned images during the course of our audits (e.g., incurred cost, forward pricing, etc.). We generally will not perform testing to the level required to determine the adequacy of system internal controls. If an auditor believes these tests of controls are necessary, the auditor should elevate their concerns to management to determine if it is appropriate to perform such tests. Without testing internal controls (access and storage controls) related to the contractor's imaging process, there is going to be a risk that the records reviewed could have been altered since the time the testing was performed. This risk is similar to the risk that the contractor has altered their hardcopy documents from the time of creation to the time of audit. Therefore, if no IT system audit has been performed to test the contractor's internal controls, the auditor must

consider fraud risk indicators and other known risk factors in determining whether there is a material chance that the scanned images have been altered since the time of testing. If the auditor identifies significant concerns, the auditor will need to make a decision as to whether a scope limitation exists relevant to the lack of testing access and storage controls.

e. If we have not tested the contractor's scanned images, auditors should determine if the contractor has preserved the original documents. If the original documents were preserved, auditors should test a sample of scanned documents to original documents to determine reliability. If the contractor did not preserve the original documents, auditors must consider the contractor's environment and review the permanent files for risk factors to ensure there is no obvious reason we should not rely on the scanned documents. Assuming no significant risk factors are identified, the auditor should complete the assignment with the scanned images, and determine if there is an impact on the audit opinion.

f. The Auditor should prepare a Memorandum for Record or summary detailed working paper if the testing did not disclose a noncompliance. If the testing discloses a deficiency, perform procedures to fully develop the finding and make a determination if a noncompliance with DFARS 252.242-7006 exists. If it is determined that a significant deficiency/material weakness exists, open a 11090 Deficiency Report assignment to report your findings. The report should, at a minimum, cite noncompliance with DFARS 252.242-7006(c)(1), Accounting System Administration, incorporating language into the notes on how the noncompliances with FAR 4.703(c) and/or 4.703(d) caused the DFARS noncompliance. Additionally, the report should comment on how the deficiency affects the reliability of the scanned images. The memorandum, detailed working paper, or report will be maintained in the respective permanent file under Section B-04, Audit Planning – Audit History.

3-2S1 Supplement-Contractor Securities and Exchange Commission Reports

The Securities and Exchange Commission (SEC) is an independent Government Agency created by the Securities Exchange Act of 1934. The laws administered by the SEC relate in general to the field of securities and finance, and seek to protect investors in their securities transactions. In addition to the 1934 Act, these laws include the Securities Act of 1933, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisor's Act of 1940. The SEC also advises the Federal courts in corporate reorganization proceedings under Chapter XI of the National Bankruptcy Act.

Under the 1934 Act, companies listing and registering securities on public trading exchanges are required to register with the SEC. Following registration, such companies must file annual and other periodic reports to keep information in the original filing current. These reports are for public review and should be available to the auditor at the contractor's corporate offices. The documents are also available for public inspection at the SEC Public Reference Room, 500 North Capitol Street, NW, Washington, DC 20549. Copies may also be requested for a nominal cost at that address. Additionally, current annual and other periodic reports (including financial statements) filed by companies whose securities are listed on exchanges also are available for inspection in SEC's New York, Chicago, and Los Angeles regional offices, as are the registration statements (and subsequent reports) filed by those companies whose securities are traded over-the-counter and registered under the 1964 amendments to the Exchange Act. Moreover, if the registrant's principal office is in the area served by the Atlanta, Boston, Denver, Fort Worth, or Seattle SEC regional offices, filing is required with the applicable regional office and reports may be examined there.

In practice, major Government contractor registrants report in rather broad segments and large dollar amounts. As a result, there may be differences in the type and depth of information in periodic statements filed with the SEC and statements issued directly to stockholders and the public. Accordingly, audits involving evaluation of contractor financial presentations should include a review of the latest statements filed with the SEC.

A brief summary of the various SEC reports most likely to be of interest to DCAA field units follows:

a. Form 8-K (1934 Act)-Current Report. This form is required 15 days after which any one or more of certain specified events occur. Some of the events which, if significant, require a report include:

- (1) changes in control of registrant,
- (2) acquisition or disposition of assets,
- (3) bankruptcy or receivership, and
- (4) changes in registrants certifying accountant.

b. Form 10-K (1934 Act)-Annual Report. This is an annual report by companies having securities registered pursuant to the 1934 Act and companies which are required to file reports under the Securities Act of 1933. Form 10-K is to annually provide information which, together with the proxy or information statement sent to security holders, will furnish a reasonably complete and up-to-date statement of the business and operations of the registrant.

c. Form S-1 (1933 Act)-Registration Statement (of Securities). This form is used for registration under the Securities Act of 1933 of securities of all issuers for which no other form

is specifically authorized or prescribed, except that the form is not used for securities of foreign governments or political subdivisions. The form includes a prospectus to inform investors. It also includes other items which are required but need not be included in the prospectus, such as expenses of issuance and distribution, indemnification of directors and officers, and recent sales of unregistered securities.

d. Form S-8 (1933 Act)-Registration of Securities to be Offered to Employees Pursuant to Certain Plans. This form is used for stock purchase, savings, or similar plans, and for registering the interests in such plans when required.

3-2S2 Supplement-Contractor Internal Revenue Service and State Taxes Reports

State and Federal Tax returns are external reporting documents, that are independently reviewed and carry substantial penalties for misstatement. As such, they provide excellent confirmation of costs claimed on contracts. Mandatory annual audit requirement No.4 on tax returns and financial statements requires the auditor to review these returns and have written confirmation of this review in the incurred cost audit files.

A brief summary of the various corporate Federal income tax return forms and schedules to be reviewed follows:

a. Form 1120 ("U.S. Corporation Income Tax Return"). Every domestic corporation not expressly exempt from tax must file an annual income tax return. A tax return is required even though there is no income or tax due and is an important source of information. Most corporations submit tax returns on Form 1120; small corporations may use Form 1120-A. Certain contract cost principles in FAR (depreciation, compensation costs, tax accruals and credits, etc.) contain reasonableness and allowability criteria directly related to the following Federal income tax schedules which are part of the Form 1120.

(1) Schedule A, "Cost of Goods Sold," provides data used in the computation of a total cost input (TCI) base and may be compared to the indirect cost rate proposal(s) if the contractor is not filing a consolidated return. The "Other Costs" section of Schedule A should be of particular interest to the auditor for unallowable costs. Schedule A also furnishes the method used for valuing closing inventory, which should be compared to permanent file data and to prior returns to identify any changes.

(2) Schedule E, "Compensation of Officers," discloses executive compensation. This compensation may be reviewed for reasonableness and may be compared to SEC filing (Form 10-K) for any differences.

(3) Schedule J, "Tax Computation," should be compared to prior years' returns for any possible organizational changes.

(4) Schedule L, "Balance Sheet," should be reconciled to the general ledger. Net assets should be compared to CAS 414 submissions; financial ratios should also be verified to determine and validate the "going concern" hypothesis.

(5) Schedules M-1 and M-2, "Reconciliation of Income" and "Analysis of Retained Earnings," respectively, should be reviewed for any unusual entries.

b. Form 1065 ("Partnership Return"). A partnership tax return on Form 1065 is required even though the firm has no taxable income for a taxable year. No tax is ever paid by a partnership; Form 1065 is an informational return. The partnership return contains data similar to Form 1120 above.

c. Form 1120S ("U.S. Income Tax Return for an S Corporation"). An S corporation (commonly referred to as a Sub S Corporation) is a domestic corporation that has elected to be taxed as an S corporation. The election permits the income of the S corporation to be taxed to the shareholders of the corporation rather than to the corporation itself.

d. Form 5500, "Annual Return/Report of Employee Benefit Plan" is the basic annual reporting requirement for employee benefit plans with 100 or more participants at the beginning of the plan year (prior to 1999). Form 5500-C, the so-called "short form", was used for employee benefit plans with fewer than 100 participants, none of whom was an owner-employee. This tax form, along with payroll tax return forms (940/941), should be considered in reviewing contractor pension costs. The IRS segment interest rate used by

the contractor to compute the pension costs under "harmonized" CAS 9904.412 can be located on Schedule SB to Form 5500.

e. Form 941, "Employer's Quarterly Federal Tax Return." A contractor or employer subject to either income tax withholding or Social Security taxes, or both, must file a quarterly return. Form 941 is the quarterly return form which combines the reporting of income and FICA taxes withheld from wages, annuities, supplemental unemployment compensation benefits, third party payments of sick pay, and other sources of income. It may also be used to verify total payroll and FICA tax expense. This form should also be reviewed to disclose any possible inclusion of unallowable interest or penalties. This tax information is reliable because it can be reconciled to total employee salaries reported to the IRS. Also, the individual W-2 forms are reviewed by the employees. The contractor should be requested to reconcile total salaries and wages to Forms 941 if the contractor's labor system has been determined to be inadequate due to deficiencies found in the contractor's payroll preparation and payment control activities.

f. Form 940 (Federal Unemployment Tax Return) This Federal tax form lists the actual state unemployment taxes paid. The Federal unemployment tax grants a credit for state tax payments, which are assessed by the state on the basis of historical probability that terminated employees of the contractor will file for unemployment compensation. The review of this form can be used to verify both Federal and state unemployment taxes and may also disclose the inclusion of unallowable penalties or interest.

g. State Tax Returns - Individual state tax returns should be reviewed to determine that the amounts claimed by the contractor agree to the amounts paid, excluding penalties and interest. Only the state tax actually paid by filing date or extension thereof is allowable (FAR 31.205-41(b)(7)).

3-300 Section 3 --- Briefing of Contracts and Requests for Proposals

3-301 Introduction

This section, as part of the chapter on audit planning, presents guidance on:

- (1) briefing the provisions of contracts and requests for proposals which may affect the contract audit workload or other aspects of the FAO's work,
- (2) notifying contracting officers of contract provisions which may impede effective contract audit or contract administration, and
- (3) implementing the DoD operations security (OPSEC) program.

3-302 Contract Briefing System

3-302.1 Objective of a Contract Briefing System

Contract clauses are reviewed to determine the specific requirements for each contract to be utilized in determining allowability, allocability and reasonableness of costs billed to the Government. Complete copies of contracts and contract modifications are usually available from the contractor, Government contract administrators, and Electronic Data Access (EDA). EDA is a database which provides electronic access to the majority of recent DoD contracts. Contract briefs are prepared to abstract, condense, or summarize pertinent contract provisions for specific audit purposes. To facilitate repetitive reviews of contracts, briefs may be maintained in a permanent file (MAAR 3) and updated on a continuous basis as contract modifications are received, or at the time of each audit depending on the frequency and type of reviews being performed. Generally, such briefs summarize information required in progress payment audits, interim voucher audits, FPI closing audits (including incentive fee computations) for fixed price contracts and final voucher audits, other incurred cost audits or reviews for cost type contracts, and defective pricing audits.

3-302.2 Auditor Reliance on Contractor Prepared Briefs

a. If the contractor's policies and procedures require contract briefs be prepared and it is cost effective to do so, evaluate this function to determine if reliance can be placed on the contractor's briefs (see 3-302.3 below). If reliance can be placed on the contractor's briefs, the basis for that reliance should be documented as discussed in 4-1000 and placed in the permanent file, including a recommendation for the review cycle of the briefing function (MAAR 3). The auditor will also need to analyze the contractor's internal controls for their use of this information to identify and segregate costs which are specifically unallowable under the contract provisions (see 8-405).

b. If the contractor does not brief contracts, or if reliance cannot be placed on the contractor's briefing function, the auditor should consider reporting this condition to the administrative contracting officer as an internal control deficiency. Also, if reliance cannot be so placed, the auditor will need to prepare briefs of the contracts. Special considerations in audits of selected contract types are provided in 3-3S1.

c. The FAO-prepared contract brief or the auditor's documentation of the contractor's brief will be maintained in the permanent files or audit working papers as appropriate. The

briefs should be reviewed by the auditor or administrative personnel to assure that required clauses are included, and clauses that are contradictory or confusing are clarified. Examples of such provisions are discussed in 3-304.1. Audit leads for special audit analysis can also be identified at this time. Contracts which have a mixture of cost-type and fixed-price provisions may be candidates for additional emphasis in floor checks or billing systems audits. Likewise, contracts with extraordinary terms affecting allowability may require special emphasis during audits or reviews of direct or indirect costs or billing systems audits.

3-302.3 Adequacy of the Contractor's Briefing System

It is not appropriate to review the contractor's briefing system internal controls if it is determined that it is more economical and cost effective to have the auditor or administrative personnel brief the contract than it is to perform the systems audit. As a result, for some contractors, only portions of their system may be audited. The scope of the systems audit should be based on the number and type of contracts, the materiality of the contracts, results of prior internal and external review or other self governance type activity, audit leads, the extent of automation, and the type of reviews for which they will be used. The briefing system audit may be performed in conjunction with a billing system audit, contract administration review, or accounting system audit. Consider the following when evaluating the contractor's briefing system.

a. Training. The contractor should provide adequate training to the employees involved in the briefing of contracts. Written policies and procedures should describe the content and frequency of the training. The course should include explanations of the types of contracts, the types of FAR unallowables, the special requirements for classified contracts and the attributes of the contractor's particular system. When evaluating the adequacy of the training, the auditor may review course material, review written documentation that the employees have been trained, review personnel records to determine prior qualifications, or interview employees to determine the extent of their training. Because the same personnel may be responsible for briefings as well as the preparation of billings, review of this area may be performed simultaneously.

b. Policies and Procedures. The contractor should have policies and procedures to describe what should be included in briefs, who will prepare briefs, who will approve them, and how they will be utilized for the various purposes for which they are prepared. The contractor may prepare preprinted or computerized forms which prompt the employee for common briefing items. Contract briefings generally include a synopsis of all pertinent contract provisions, such as contract type, amount, product or services to be provided, applicable cost principles, performance period, OPSEC measures (3-305), rate ceilings, advance approval requirements, precontract cost allowability or limitations, and billing limitations. When evaluating the briefs, the auditor should review the special considerations identified in 3-3S1 to determine adequacy. (For guidance on provisions impeding contract administration see 3-304.) The contractor may not brief all provisions of the contract, but may have alternate procedures. For example, if the contractor has adequate procedures for excluding unpaid costs from all interim vouchers, the applicable contract clause or reference to it may not be needed on the brief.

3-303 Requests for Proposals

a. When audit of a contractor's price proposal has been requested (see 9-100), the FAO will brief the related request for proposal (RFP) to identify requirements that may affect the audit. The PCO should provide the applicable portions of the solicitation (RFP or request for quotations (RFQ)) with the audit request, particularly those describing requirements and delivery schedules.

b. Include the auditor's briefing notes in the working papers for the proposal assignment. If OPSEC measures (3-305) are required, promptly inform all DCAA personnel who may be affected.

3-304 Reporting on Provisions Impeding Effective Contract Audit or Administration

3-304.1 Examples of Impeding Provisions

The following are provisions of contracts or RFP/RFQs that may impede effective contract audit or contract administration and are therefore subject to special reporting:

a. Defects in or omissions of required contractual provisions, such as omission of contract clauses requiring contractors to maintain adequate accounting records when cost determinations are a factor or providing the Government the right to audit.

b. Undesirable or ambiguous provisions, such as provisions for rate changes or price redeterminations at times or under conditions which cannot be implemented or efficiently administered.

c. Provisions which exclude portions of costs from verification, limit in any way the Government's right to audit, or restrict the scope of the audit.

d. The award of a contract type incompatible with the contractor's accounting system (see FAR 16.104(h)).

e. Contracts having the characteristics of cost-plus-a-percentage-of-cost contracts, such as negotiation of contract value after contract completion.

f. Any other provisions which are not clearly stated and which may lead to subsequent misunderstanding or dispute in the audit or in the administration of the pricing provisions of the contract.

g. Provisions which are contradictory to or inconsistent with existing statutes or regulations, including Cost Accounting Standards, and/or contractor practices, such as requiring that direct contract costs be allocated to multiple contracts.

3-304.2 Reporting to the Contracting Officer

If you find provisions in a contract or RFP/RFQ that may impede effective contract audit or administration, promptly notify the contracting officer, suggesting appropriate action. You should also coordinate with the ACO to obtain clarification on contract terms that are new to you, unclear, or you have questions on intent.

3-304.3 Internal DCAA Reporting

a. Differences between the contracting officer and the auditor which cannot be resolved locally will be referred to the regional director by way of the regional audit man-

ager. The referral will advise the regional director regarding the basis of the disagreement and the actions taken to resolve the issue. The regional director will then decide whether direct communication with the responsible procurement office is needed.

b. Where corrective action is not taken within a reasonable time and where the issue involved is deemed to have policy impact or may have a significant monetary impact, the regional director will submit a report to Headquarters, Attention PPD, containing the following information:

- (1) Summary of the situation and actions taken by the regional director.
- (2) Summary of discussions with the contracting officer.
- (3) Any other pertinent information.
- (4) The regional director's recommendations.

c. Headquarters will advise the regional director of the actions taken on each case and the final resolution of the problem area.

3-305 DCAA Implementation of the DoD Operations Security (OPSEC) Program

a. The DoD OPSEC program, policy, and responsibilities are contained in DoD Directive 5205.2. The OPSEC program applies to DoD contractors participating in the DoD Industrial Security Program when such measures have been determined essential for the adequate protection of classified information with respect to a specific classified contract. The Head of the responsible DoD Component makes the determination as to the applicability of the OPSEC program requirements to the contract. Thus, the OPSEC program ensures the protection of DoD programs, operations, and activities by maintaining essential secrecy through the protection of classified materials and information. The guidance which follows constitutes DCAA's implementation of DoD Directive 5205.2.

b. Normally, FAOs will not need to have direct access to information in the DoD Directive; however, a copy may be obtained from a DoD publications distribution office if further information is desired. When briefing any classified contract or RFP/RFQ, carefully note any OPSEC measures required of the contractor. Required OPSEC measures may have an impact on the contractor's pricing and costing of a contract. Also, DCAA personnel must comply with any OPSEC measures required by a contract or RFP/RFQ. Direct questions concerning OPSEC measures to either the regional security officer or contract administration officials.

**3-3S1 Supplement --- Special Considerations in Audits
of Selected Contract Types**

<u>Cost Reimbursable Contracts</u>	<u>T&M and Labor-Hour Contracts</u>	<u>Fixed Price Contracts</u>
<u>1. FAR Citations</u>		
FAR 52.216-7	FAR 52.232-7	FAR 52.232-16, 32.5, 42.7
<u>Accrued Versus Paid Cost</u>		
Billed costs do not include accrued costs (not paid) for items or services purchased directly for the contract.	Same as cost reimbursable.	Same as cost reimbursable.
<u>For purposes of interim reimbursement.</u> Allowable costs include recorded costs of items or services purchased directly for the contract for which the contractor has paid (small business concern may bill these costs even though the concern has not yet paid for them) and costs incurred, but not necessarily paid for materials issued from the inventory and placed into production, direct labor, direct travel, other direct in-house costs, allowable and allocable indirect costs, and progress payments or interim vouchers paid to subcontractors.	Same as cost reimbursable for the ODC or material portions of the contract. Labor, applicable burden and profit is billed at a category rate applicable to actual hours or man days, etc.	Same as cost reimbursable.
<u>For final vouchers.</u> Allowable costs include all paid costs, including reimbursable subcontracts and interdivisional transactions which must have been closed out and for which required final audits have been performed.	Same as cost reimbursable for the ODC or material portions of the contract. Labor, applicable burden and profit is billed at a category rate applicable to actual hours or man days, etc.	The allowable amount is the excess of the contract price over the amount required to liquidate progress payments.
<u>Delinquent Payments</u>		
<u>For interim vouchers.</u> Billed costs do not include accrued costs that the contractor is delinquent in paying for in the ordinary course of business.	Same as cost reimbursable for the ODC and material portions of the contract.	Same as cost reimbursable.
<u>Unallowable Cost</u>		
Billed costs do not include unallowable costs.	Same as cost reimbursable for the ODC and material portions of the contract.	Same as cost reimbursable.
<u>Pensions, etc.</u>		
Billed costs do not include accrued costs of pensions, post retirement benefits, profit-sharing or employee stock ownership plans that have not been paid at least quarterly (within 30 days after the end of the quarter).	Same as cost reimbursable for the ODC and material portions of the contract.	Same as cost reimbursable.

Cost Reimbursable Contracts	T&M and Labor-Hour Contracts	Fixed Price Contracts
2. Ceiling or Funding Limitations		
<p>Cost type contracts may set ceilings on indirect rates, on specific elements, and on contract line items. These ceilings may apply on an interim or interim and final basis. The contractor cannot be reimbursed for costs in excess of the identified ceiling.</p>	<p>Same as cost reimbursable.</p>	<p>Not applicable.</p>
<p>The contract will provide funding limitation amounts which are less than the contract value until the contract fully funded. These limitations are not to be exceeded on an interim basis and on a final basis the contract should not claim costs in excess of the estimated total amount stipulated in the contract.</p>	<p>Same as cost reimbursable.</p>	<p>Same as cost reimbursable.</p>
<p>See also 11-100 for guidance on the limitation of cost clause.</p>	<p>Not applicable.</p>	<p>See also 11-100 for guidance on the Limitation of Payments Clause. Progress Payment and Liquidation rates are specified in the contract.</p>
3. Cost Sharing Arrangements		
<p>Contracts may identify percentages or absolute values in excess of which the Government will not reimburse costs.</p>	<p>Not applicable.</p>	<p>Not applicable.</p>
4. Retentions and Withholds		
<p><u>Patent Rights and Technical Data Withholds.</u> The contract may provide for temporary withholding of amounts as reserves from payments otherwise due to the contractor, to assure performance of certain contractual requirements. FAR 27.305-2(e) provides that if the contractor fails to furnish certain reports relative to inventions developed by the contractor under the contract, the contracting officer may invoke the withholding of payments provision of the patent rights clause (52.227-13(g)) which states that the Government may withhold payment until a reserve not exceeding \$50,000 or 5 percent of the amount of the contract, which-</p>	<p>Not applicable.</p>	<p>Not applicable.</p>

Cost Reimbursable Contracts	T&M and Labor-Hour Contracts	Fixed Price Contracts
<p>ever is less has been set aside. Similarly, the clause in DFARS 227.473-5 provides for withholding of 10 percent of the allowable costs and fixed fee from payment on an interim basis when the contractor does not deliver certain technical data required by the provisions of the contract.</p>		
<p><u>Fee Withholds.</u> For payments of the fixed fee under cost-reimbursement contracts, FAR 52.216-8(b), 52.216-9(c) and 52.216-10(c) all provide for the withholding of the fee on an interim basis after payment of 85 percent of the fixed fee until a reserve is set aside in an amount that the contracting officer considers necessary to protect the Government’s interest. The reserve will be from 0-15 percent of the total fixed fee or \$100,000, whichever is less. Based on the contract terms, the percent will be specified or determined at the discretion of the contracting officer.</p>	<p>Not applicable.</p>	<p>Not applicable.</p>
<p>Not applicable.</p>	<p><u>Hours Withhold.</u> FAR 52.232-7(a)(7) states that unless otherwise prescribed in the Schedule, the contracting officer may unilaterally issue a contract modification requiring the contractor to withhold 5 percent of the amounts related to the billable hours, not to exceed a total of \$50,000 for the entire contract. The withholding will apply to the billable hour portion only, and not to direct material or sub-contract amounts. The same provision for time-and-materials contracts also applies to indefinite-delivery-type contracts which may be identified by a “D” in the ninth position of the Procurement Instrument Identification Number (contract number).</p>	<p>Not applicable.</p>

<u>Cost Reimbursable Contracts</u>	<u>T&M and Labor-Hour Contracts</u>	<u>Fixed Price Contracts</u>
5. Required Frequency of Billing		
Interim vouchers and final vouchers on completed or terminated contracts and subcontracts are submitted for payment on time intervals provided for by the contract for both negative and positive billings. The contractor may have threshold criteria that must be met in order to bill besides the time intervals provided below, such as a dollar value threshold. Gain an understanding of the reasons for these other thresholds.		
<u>Interim Vouchers.</u> The contractor may submit an interim invoice or voucher as work progresses (but generally not more often than once every two weeks for large contractors) in amounts supported by a statement of the claimed allowable costs for the period.	Vouchers may be submitted not more than once every two weeks. A small business concern may receive more frequent payments than every two weeks.	Vouchers may be submitted only once a month.
<u>Final vouchers on completed contracts.</u> The contractor shall submit a final voucher to reflect the settled amounts and rate within 120 days (or longer, as the contracting officer may approve in writing) after settlement of the final annual indirect costs rates for all years of the physically completed contract per FAR 52.216-7(d)(5). Care should be taken that final or quick close-out rates (6-1010) are determined, and subcontract or interdivisional transactions have been properly closed out.	Same as cost reimbursable.	Final invoices are submitted only once a month.
<u>Final vouchers on terminated contracts.</u> On terminated contracts the final voucher may be submitted at the end of the vouchering out period (12-402) or after completion of the termination negotiations.	Same as cost reimbursable.	Not applicable.
6. Profit or Fee		
Fees may be of the fixed, award or incentive type. Contract types and computational methodology are discussed in detail in FAR Part 16 and DLAM Fees may be billed with cost or may be separately vouchered.	These contracts provide for (1) billing direct labor (including subcontractor direct labor for T&M/LH contracts awarded on or after February 12, 2007) at negotiated hourly labor rates by labor category, which include all applicable burden and profit, and	Profit may be fixed or incentive or the contract may require economic price adjustments. Contract types and computational methodology are discussed in detail in FAR Part 16 and DLAM.

Cost Reimbursable Contracts	T&M and Labor-Hour Contracts	Fixed Price Contracts
	(2) billing other direct costs (ODCs); direct materials on T&M contracts, and subcontract costs (including subcontractor direct labor for T&M/LH contracts awarded before February 12, 2007) at cost plus applicable burden (no profit).	
<p><u>For interim payments.</u> The contract terms specify how the fee will be computed on an interim basis. Generally, fee is billed as a percentage of incurred cost until it meets any funding withhold limitations. (Fee withholds are explained in 4 above.) However, Award fees are generally the subject of a special contract modification and the specific amount to be billed is given.</p>	<p>Profit is billed as part of the rate.</p>	<p>Contract line items are billed at price unless progress payments or advance payments are allowed.</p>
<p><u>For final vouchers.</u> The fee is calculated in accordance with the terms of the contract.</p>	<p>Profit is billed as part of the rate.</p>	<p>Contract line items are billed at price less any credit for liquidating progress payments.</p>
<p>7. Forms and Documentation Requirements</p>		
<p>The submission form (SF 1034 for paper vouchers or 'Cost Voucher' in Wide Area Workflow) is approved by the auditor or contracting officer. Detailed information concerning the preparation, submission and processing of these forms is presented in DCAAP 7641.90. This pamphlet is available for distribution to contractors.</p>	<p>Same as cost reimbursable.</p>	<p>For progress payments the SF 1443 is used. Instructions for the SF 1443 are on the back of the form.</p>
<p>The contract generally identifies the cognizant DCAA office responsible for processing vouchers.</p>	<p>Same as cost reimbursable.</p>	<p>Not applicable.</p>
<p>Special submission forms or data may also be identified at the same time. COTRs (Contracting Officers Technical Representative) may be identified and documentation and voucher routing requirements specified for their approval of work performed.</p>		

<u>Cost Reimbursable Contracts</u>	<u>T&M and Labor-Hour Contracts</u>	<u>Fixed Price Contracts</u>
8. Performance Period.		
A contract may provide that it expires on a specified date, unless terminated before that date, and obligates the contractor to devote a specified level of effort for a stated time period (FAR 16.306(D)(2) and FAR 52.249-6(a)). The auditor shall not approve for reimbursement any costs incurred by the contractor subsequent to the expiration date stated in the contract, or in excess of contract limitations.	Same as cost reimbursable.	A fixed price contract requires specific delivery dates for item. Missing these dates may result in penalties.
9. Specified Completion or Delivered Product.		
A completion or delivered product specified in a cost-type contract normally commits the contractor to complete and deliver the specified product within the estimated cost. In the event the work cannot be completed within the estimated cost, the Government may require more effort without an increase in fee (FAR 16.306(D)(2) and FAR 52.249-6(a)). The auditor shall not approve for reimbursement any costs incurred by the contractor subsequent to the expiration date stated in the contract, or in excess of contract limitations.	Not applicable.	Not applicable.
10. Other Provisions		
<u>Overtime Premium.</u> Overtime premium is probably the most frequently limited cost and is generally identified in the contract's FAR clauses section, FAR 52.222-2. The clause identifies an amount from \$0 upward in excess of which the contractor cannot bill.	The contract may provide a category rate to be applied to overtime hours, the contract may specify the number of hours allowable, it may specify the type of work or type item it is allowable on, or who will approve it.	Not applicable.
<u>Other.</u> Other contract provisions are generally identified in the H-section of the contract. They may include allowance criteria or conditions (cost ceilings or time frames) for certain costs such as precontract costs (also see FAR 31.205-32), costs incurred after the completion or delivery date specified in the contract, or costs incurred in excess of the contract amount.		

<u>Cost Reimbursable Contracts</u>	<u>T&M and Labor-Hour Contracts</u>	<u>Fixed Price Contracts</u>
First Article Approval. Not Applicable.	Not applicable.	A fixed price contract may require first article approval (FAR 52.209-3 or -4) before the contract is eligible for progress payments.

3-400 Section 4 --- Internal Control Audit Planning Summary (ICAPS)

3-401 Introduction

This section provides guidance on using the Internal Control Audit Planning Summary (ICAPS) to summarize the auditor's assessment of control risk and the impact on related contract audit effort. The ICAPS sheets are automated through the Internal Control Review System (ICRS) database. The ICRS database software should be installed and used at each FAO that performs any of the ten accounting and management system reviews listed in section 5-102 (e.g., FAOs cognizant of both major and nonmajor contractors where internal control reviews are performed). The ICRS software is described in detail in the "Help" menu, which is available through the applications menu options. For guidance on performing reviews of contractor accounting and management systems, and related internal controls, see Chapter 5.

3-402 Background Information

a. As discussed in 3-200, the auditor's assessment of control risk is a critical factor in determining the nature and extent of audit effort necessary to achieve the objectives of the individual audit assignment in an effective and efficient manner. To assess control risk, the auditor must carefully evaluate the controls over each significant contractor accounting and management system that could impact the scope of that particular audit. Due to the number of contract audits performed at some contractors, it is both impractical and inefficient to duplicate all the audit steps necessary to assess control risk as part of each individual audit assignment. Therefore, separate audit assignments are established to evaluate each significant contractor accounting and management system, and the related controls, on a periodic basis. The results of these internal control audits are used by other auditors to plan the scope of related audit effort.

b. The ICAPS is the primary means of communicating the results of the internal control audits to the auditors performing the related audit effort. It contains information pertaining to the control risk assessments resulting from the internal control audits, along with a brief description of how these assessments may impact the scope of other related contract audit effort. The ICAPS becomes part of the FAO's permanent file for use by other auditors to quickly understand the level of control risk associated with the contractor's accounting and management systems, and the potential impact on their individual audit assignments. The auditor performing related audit effort will consider the information included in the ICAPS, along with other risk factors, in determining the scope of related audit effort.

3-403 Relationship of ICAPS and Mandatory Annual Audit Requirements (MAARs)

a. A general discussion of MAARs appears in 6-105. A tabulation of the MAARs, including title, objectives, purpose, and principle CAM reference, appears in 6-1S1.

b. Many MAARs require transaction testing and other auditing procedures that are likely to be covered during incurred cost audit assignments. The scope of such evaluations is affected by the strength of the contractor's internal controls and how current the audit experience is in the area. Internal controls affecting the MAARs are summarized in the ICAPS for each related contractor accounting and management system. For example, internal controls affecting MAAR 6, Labor Floor Checks or Interviews, are summarized in the ICAPS for the

contractor's labor accounting system. It is often possible to reduce the scope of a mandatory evaluation when the contractor's internal controls in the area are strong. Conversely, it may be necessary to expand the scope of a mandatory evaluation to cover audit risks identified in the ICAPS. However, the focus of the auditor's efforts should be to work with the contractor and ACO to reduce risk ratings, rather than to continue performing expanded testing.

3-404 Audit Policy on ICAPS

a. At major contractors, a separate ICAPS will be maintained for each of the ten management and accounting systems, identified in 5-102. However, control risk should only be assessed for those systems that process a material amount of transactions that are ultimately assigned to Government contracts. ICAPS will also be maintained for nonmajor contractors when internal control audits are performed for systems processing a material amount of transactions that are ultimately assigned to Government contracts. The ICAPS form is the summary audit working paper for the audit of the internal control system and related internal controls. Information from the forms should be retained in the permanent file via the ICRS database.

b. Significant information contained in the ICAPS, either positive or negative, should be communicated to the appropriate auditors immediately (e.g., risk information on the ICAPS for the estimating system should be communicated to auditors performing audits of individual price proposals).

c. Generally, since the ICAPS is intended to support the audit planning process, each ICAPS (including related continuation sheets) should stand on its own. Each ICAPS should contain sufficient information for auditors to determine the impact of the control risk assessment to properly plan the scope of other related contract audit activities. In most cases, it should not be necessary for auditors performing related audits to conduct detailed reviews of the internal control audit working papers to determine the impact of the control risk assessment on related audit activities. While the following paragraphs provide general guidance on completing the ICAPS form, auditors should exercise professional judgment in determining the exact nature and extent of information necessary to meet the needs of the auditors performing related audit effort in their individual audit circumstances.

3-405 Preparation of the Internal Control Audit Planning Summary

Figure 3-4-1 contains a generic copy of the ICAPS form. The specific ICAPS for each of the ten systems is delivered by APPS as part of the audit summary working paper A. As discussed above, a separate ICAPS form should be maintained for each significant contractor accounting and management system. The ICAPS form is updated during the normal cyclical audit of each significant system and related internal controls.

3-405.1 Materiality and Sensitivity

As discussed above, DCAA is only concerned with assessing the adequacy of internal controls for those contractor accounting and management systems that may significantly impact the pricing, administration, or settlement of Government contracts. This section of the ICAPS provides information concerning the significance of each system for each Con-

tractor Fiscal Year (CFY). In addition, it provides a brief summary of any sensitivities that may impact the scope of other related audit effort.

a. Materiality is determined based on the importance of the contractor accounting or management system relative to Government contracts. While all major contractors generally accomplish the functions associated with the ten accounting and management systems identified in 5-102, the materiality/significance of these systems will vary from contractor to contractor. Therefore, it is important for the auditor to understand the dollar value of transactions processed by the system and assigned to Government contracts, both flexible and fixed price, and their significance in relation to:

- (1) the total dollar value of transactions processed by the system,
- (2) total Government contract costs, and
- (3) total contractor operations.

To illustrate, the auditor's determination of materiality for a contractor's labor system should consider the total dollar value (order of magnitude) of labor transactions (e.g., \$100 million) processed by the system, in relation to the order of magnitude of the contractor's total operation (e.g., \$1 billion cost of sales). The auditor should also consider the Government's participation, both flexible and fixed price, in the system's transactions, as well as within the contractor's total operations. For example:

	System	Contractor
Total Dollars	\$100 million	\$1,000 million
Gov't Flexibly Priced Dollars	\$ 20 million	\$ 80 million
Gov't Fixed Price Dollars	\$ 25 million	\$ 170 million

b. Sensitivity is determined based on how given matters will impact the judgment of the users of contract information. For example, inclusion of some unallowable costs (e.g., luxury yachts, dog kennels) have a more significant impact on users of contract information than clerical errors or inadvertent mistakes. In addition, some costs may be more sensitive than others due to congressional interest or other internal and external factors. The emphasis placed on consultant costs during the late nineteen eighties is an example of an external factor. Internal factors include events such as changes in the contractor's corporate structure and implementation of major new software packages, such as ERP. Section I.2 of the ICAPS is designed to summarize any unusual or unique sensitivities applicable to the system in question.

c. The auditor should carefully consider the system materiality and sensitivity in determining the timing, nature, and extent of internal control audit effort. If a particular system is not considered material for the current year, there is no need to assess control risk further. The basis for this assessment should be documented on the ICAPS and filed in the permanent files for reference and review/update in future years.

3-405.2 Control Risk Assessment

This section of the ICAPS is designed to summarize the auditor's assessment of control risk for each relevant control objective based on the results of the system audit. 5-109 contains detailed guidance on assessing control risk.

a. The auditor should first identify each of the relevant control objectives for the system being summarized. 5-300 through 5-1200 contains details regarding the relevant con-

control objectives for each contractor accounting and management system. For example, the relevant control objectives for labor accounting are covered in 5-900, and are summarized as follows:

- (1) Management Reviews
- (2) Employee Awareness Training
- (3) Labor Authorization and Approvals
- (4) Timekeeping
- (5) Labor Distribution
- (6) Labor Cost Accounting
- (7) Payroll Preparation and Payment
- (8) Labor Transfers and Adjustments

b. For each relevant control objective, the auditor should summarize the control risk assessment (low, moderate, or high) contained in the detailed working papers for the system audit (see 5-109).

c. The auditor should also indicate the system audit report number and date in which the control risk assessment for any control objective was most recently updated. As more current information becomes available, the auditor's assessment of control risk may change. For example, the contractor may correct a previously reported deficiency, or subsequent system audit effort may indicate failures to comply with established policies and procedures. In these instances, the auditor should update the ICAPS upon issuance of the system audit report that resulted in the change in the control risk assessment. Under no circumstances should the ICAPS be updated for potential changes in the control risk assessment that have not been formally reported.

d. The last section of the control risk assessment requires the auditor to explain on continuation sheets all moderate or high risk assessment ratings. Ratings of moderate or high risk should be supported by significant reported deficiencies. The auditor should provide sufficient information regarding the deficiencies to facilitate the planning of other related audit effort. Sufficient information should be provided for the auditor performing related audit effort to understand the nature of the deficiency that resulted in the moderate or high risk assessment.

3-405.3 Overall System

a. In addition to assessing control risk for each of the relevant control objectives, the auditor should determine whether the system is adequate to reasonably assure proper pricing, administration, and settlement of Government contracts. The determination as to whether the overall system is adequate or inadequate should be based on the significance of the deficiencies and the extent of reliance, if any, that can be placed on information coming out of the system. Making such a determination requires the exercise of considerable audit judgment. A single significant deficiency/material weakness or the contractor's failure to accomplish a single control objective would render the entire system inadequate (see 5-109).

b. The auditor's assessment of the overall system should be consistent with the audit opinion contained in the most current report on the system in question, and with the risk ratings assigned to the relevant control objectives. For example, in the case of a labor system audit, if high risk ratings have been assigned to labor cost accounting and labor transfers and adjustments, it would be expected that the overall system opinion would be inad-

equate or inadequate in part. Although flash reports may be used as a basis for increased substantive testing recommendations for related audits, they should not be used as a basis for revising the control risk assessment or revising the assessment of the overall system. Any change in the auditor's assessment of the overall system must be based on a written report on the audit of the internal control.

3-405.4 Impact on the Scope of Other Audits

a. The audit planning process involves not only assessing control risk, but also identifying the potential impact of these risk assessments on other related audit effort. Section IV of the ICAPS is designed to highlight the impact that the auditor's control risk assessment has on related audit areas. These audit areas are summarized as follows:

- (1) Contract Pricing
- (2) Defective Pricing
- (3) Incurred Material Costs
- (4) Incurred Labor Costs
- (5) Incurred Indirect/ODC Costs
- (6) Contract Reporting
- (7) Billings
- (8) Closeouts
- (9) Financial Capability
- (10) CAS

b. The impact on the audit scope section should identify the general level (minimum or increased) and nature of substantive testing needed as a result of the control risk assessments. The minimum level of substantive testing is the level required when the auditor can be expected to rely on the contractor's system for that particular audit area. The minimum level of substantive testing varies depending on the nature of the audit. Accordingly, the auditor performing the related audit must determine the minimum level of substantive testing (i.e., analytical procedures and/or transaction tests) for each related audit based on the particular circumstances of that audit. A recommendation for increased substantive testing in this section means substantive testing over and above the minimum level (not the level historically performed at the contractor) that may be required because a deficiency in the system results in an increased risk of material errors or misstatements. The extent of increased testing required for a particular related audit area will vary depending on the nature of the audit, and materiality and sensitivity considerations. Generally, assessments of low control risk should result in minimum substantive testing and assessments of moderate and high risk will result in increased testing.

c. When increased substantive testing is recommended, sufficient information should be included on continuation sheets regarding the impact on the scope of other related audits. The amount of information required will vary depending on the nature of the deficiency resulting in the increased testing recommendation. The information should be sufficient to enable the auditor performing other related audit effort to determine the nature and extent of substantive testing required, including to the extent practical, information regarding:

- the types of errors that could occur as a result of the deficiency;
- the types or classes of transactions that could be impacted by the deficiency;

- the circumstances under which the errors are likely to occur; and
- the types of substantive tests that could be used to detect the errors.

d. Generally, assessments of low risk should result in recommended reductions in the scope of related audits, unless the scope has previously been appropriately reduced, which should be documented and explained. Section IV of the ICAPS should also be used to communicate any additional information considered necessary to ensure proper consideration of control risk assessments in related audit effort. For example, this section should identify any flash reports that have been issued since the last full system audit was performed, and note the impact that the deficiencies in the flash report would have on related audits. This section should then be updated when the system audit following up these deficiencies is completed (5-110c(3)).

3-406 Updates and Revisions -- ICAPS

a. Changes to the control risk assessments in the ICAPS should be based on reported conditions in system audits or follow-up system audits. Prior versions of the ICAPS should be retained in the permanent file for reference. In no circumstances should the control risk assessment (Section II) or overall system opinion (Section III) be updated unless there is a system audit report supporting the change. Flash reports, that disclaim an opinion (10-413.3b), should not be used as a basis for updating Sections II or III of the ICAPS.

b. Since contractor internal controls are audited on a cyclical basis, it may become necessary to update Section IV of the ICAPS, Impact on the Scope of Other Audits, prior to the next scheduled system audit. For example, audits of individual pricing proposals may identify deficiencies in the contractor's estimating system that did not exist or were not identified at the time of the last system audit. In these instances, Section IV of the ICAPS should be updated to note/reference the reported deficiencies (e.g., flash reports) and reflect the impact on other related audit effort. The control risk assessment and the impact on other related audit sections should be updated when the FAO completes the internal control audit following up the deficiencies (5-110c(3)).

c. Auditors should also be alert for factors that may indicate the current control risk assessment may be invalid. These factors may include:

- (1) material amounts of questioned cost in individual audit assignments,
- (2) recurring questioned costs of an immaterial amount,
- (3) significant turnover in contractor personnel,
- (4) contractor reorganizations, and
- (5) flash reports.

In these instances, it may be necessary to increase the scope of related audit effort. However, the auditor should also consider performing a system audit (5-103a) to reevaluate the contractor's internal controls and encourage contractor corrective action for any identified deficiencies. Getting the contractor to correct the system is generally a more effective and efficient way to protect the Government's interest in the long run.

Figure 3-4-1
Internal Control Audit Planning Summary

Assign. No. _____
Report Date _____

DEFENSE CONTRACT AUDIT AGENCY
INTERNAL CONTROL AUDIT PLANNING SUMMARY
FOR THE _____ SYSTEM OF

(Contractor Name)

.MATERIALITY AND SENSITIVITY

1. Materiality (For CFY Ending: _____)

	System	Contractor
Total Dollars	_____	_____
Gov't Flexibly Priced Dollars	_____	_____
Gov't Fixed Priced Dollars	_____	_____

2. Sensitivity

II. CONTROL RISK ASSESSMENT

<u>Control Objectives</u>	Control Risk			Reference to <u>Support Assessment</u>
	<u>Low</u>	<u>Moderate</u>	<u>High</u>	<u>Report No./Date</u>
1.				
2.				
3.				

Include working paper references or explanation to support all risk assessments. Describe the significant reported system deficiencies that support all moderate or high control risk assessments on continuation sheets.

III. OVERALL SYSTEM

Adequate: _____ Inadequate: _____

IV. IMPACT ON THE SCOPE OF OTHER AUDITS

<u>Audit Areas</u>	<u>Required Substantive Testing</u>			Reference to Continuation Sheet that Describes the General Scope of Required <u>Substantive Testing</u>
	<u>Minimum</u>	<u>Increased</u>	<u>N/A</u>	
Contract Pricing				
Defective Pricing				
Incurred Material Costs				
Incurred Labor Costs				
Incurred Indirect Costs				
Incurred ODC Costs				
Contract Reporting				
Billings				
Closeouts				
Financial Capability				
CAS (Specify type – i.e., specific standard, D/S, or cost impact, of if increased testing is identified.)				
Other _____				

Where testing is indicated as increased, describe the general scope of the required substantive testing on continuation sheets. The information should be sufficient to enable the auditor performing other related audit effort to determine the nature and extent of substantive testing required (see CAM 3-405.4c). Also, describe on the continuation sheet any deficiencies in the contractor's system that did not exist or were not identified at the time of the last system audit (e.g., flash reports).

3-S10 Supplement --- Reserved**3-S20 Supplement --- Recommended Areas of Coverage for Audits of National Aeronautics and Space Administration Contracts (Ref. 15-106)****3-S201 Introduction**

a. The following paragraphs set forth areas of audit coverage considered to be of importance in the audit of large dollar value NASA contracts. These areas have been suggested and identified by NASA procurement personnel as particularly significant in view of that agency's contracting policies and procurement management programs. It will be noted that with the exception of the special coverage set forth for NASA Form 533, these areas would also normally be encompassed in the audit program of DoD major contractors. Consequently, the integration of proper coverage for these areas into the audit plan for contractors having a large volume of DoD and/or NASA auditable contracts should not present any additional work.

b. The scope of audit and the extent of coverage to be accorded to the individual areas will be determined by the DCAA auditor, who is fully responsible for the development of the audit plan and its performance. In any event, it would be expected that the DCAA auditor would have carefully considered the matters presented below, to the end that the overall audit plan will provide adequate coverage of the contractor's total auditable activities and contracts.

c. Where requests for special audit coverage or emphasis are received from NASA procurement or audit personnel, they should be considered in the light of the foregoing, for orderly performance in accordance with the audit plan. If performance of any such request will adversely affect accomplishment of the audit plan, the DCAA auditor will discuss the matter with the regional director prior to reaching a decision on the request. When deemed necessary, the regional director may also consult with Headquarters, DCAA, regarding the request.

3-S202 Performance Controls

In view of the technical ramifications of this area of activity, it is recommended that any performance problems disclosed be coordinated with responsible technical project personnel. Illustrative of the types of matters warranting attention and coverage are:

a. Disproportionate relationship of production schedules to contractual delivery requirements.

b. Excessive rework of subsystems, component parts, etc. In this connection, ascertain whether vendor-fabricated components reworked by the company should have been returned to vendors for rework or replacement at their own expense because of failure to meet specifications.

c. Lack of consideration of available facilities and plant capacity in development of production schedules.

d. Significant production slippages. The related impact on costs and personnel utilization should be explored and emphasized. The steps taken or planned, if any, to recoup schedule losses, etc., should be reported.

3-S203 Contractor Financial Management

a. All actual and potential cost overrun conditions should be appropriately analyzed for each contract. To the extent feasible, explore and report the contributing factors such as:

- (1) Misunderstanding of work requirements.
- (2) Inadequate cost estimating procedures.
- (3) Ineffective coordination between the contractor's technical and administrative officials at the time that redirection of effort or changes in scope are undertaken.
- (4) Poor communication to or reporting among the prime and subcontractor representatives. For example, subcontractors sometimes incur cost overruns long before the prime contractor or NASA knows. Reports between the above, if made on a timely basis, would in many instances predict the overrun or the underlying problems.

b. Audit coverage of this area should include an assessment of the contractor's policies and procedures for development and maintenance of historical costs and forecast data to be used in preparing financial management reports, price proposals, etc.

c. Review should also be made of the company's procedures for preparing annual company-wide budgets and for comparing on a periodic basis incurred costs with budget data (5-500). Matters which should be considered include the following:

(1) Adequacy of budgetary controls for individual NASA contracts. In this connection, determine whether the estimated costs of individual projects, tasks, and departments, as included in the contractor's bid proposals, agree with (a) the amounts budgeted for the individual projects, tasks, and departments and (b) the total estimated costs shown in the Forms 533 or equivalent reports. Also, ascertain whether costs incurred are accounted for in a manner to permit comparisons with the estimated costs of individual project tasks and departments, as shown on the contractor's price proposal and budget. The evaluation should cover the adequacy and reliability of the data generated by the contractor's system as well as the use made of these reports by the contractor.

(2) The NASA FAR Supplement 4.675 provides for contractors to report periodically on NASA Form 533 (Contractor Financial Management Report) to NASA field installations. This form is designed for contractors to submit their financial and manpower experience and projections. Contractors are required to furnish a separate report periodically for each NASA cost-reimbursement type contract on which the estimated cost is expected to be \$500,000 or over and on which the period of performance is expected to be one year or more. Contracting officers may also require submission of this report, where deemed advisable, for contracts not meeting these criteria.

d. Auditors should selectively review the current reports for each contract as follows:

(1) Current cost experience and engineering estimates are normally required to be used in reporting the estimated cost to complete the contract. The auditor should ascertain whether such estimates were used and whether the amounts reported in the form agree with the estimates. There should be logical explanations for any differences.

(2) Where current cost experience and engineering estimates are not used, the auditor should evaluate the methods used for reporting the estimated cost to complete. In some instances, contractors arrive at these amounts by merely deducting the cumulative incurred cost to date from the total contract amount (exclusive of fee). This procedure is unrealistic, particularly where known cost overruns have already occurred in certain phases of contract performance. Since subcontract costs are often a substantial part of

the total, it is particularly significant that the contractor's procedures for obtaining realistic subcontract data be reviewed for adequacy.

(3) The auditor should ascertain whether the contractor's procedures for internal review of NASA Forms 533 prior to their issuance are adequate. For example, if the reports are prepared by the accounting department, they should, as a minimum, be reviewed by the contractor's cognizant contract manager to insure their accuracy and currentness.

(4) Where there is a significant upward trend in labor costs, the reasons therefore should be ascertained and reported. Some of the reasons for this condition may be (a) improper controls over production methods, resulting in failure to detect inefficiencies or (b) increases in hourly rates without a corresponding increase in productivity.

(5) Causes for excessive or unusual increases in overhead and G&A expense rates during the course of contract performance should be analyzed. Evaluate action taken by the contractor to control the rates.

e. In some cases, the data and reports submitted to NASA are generated by a separate system from that used by the contractor for internal control of its functions and organizations. In these situations, the auditor should ascertain whether the data generated by the system used for contractor purposes are fully compatible with the data submitted in reports to NASA. All pertinent data should be reported to NASA regardless of whether required by the NASA reporting system.

f. In those cases where PERT or an equivalent system is required by NASA for control of project operations, the auditor should evaluate the adequacy of the system to establish:

(1) Whether duplicate PERT or related systems are being used by the contractor. The basic NASA-PERT system policy requires establishment of only summary-type networks and cost reports thereon. Use of the PERT system at lower levels is generally optional to the contractor. However, if PERT networks are developed at a lower level of detail than that required by NASA, determine whether the contractor's project managers are actually using the more detailed PERT system or relying on a separate system of their own.

(2) Whether the costs of operating the NASA-PERT system are charged both as direct and indirect costs. Inasmuch as many of the activities associated with the operation of the system are closely related to the general process of management, that is, project management, planning, scheduling, accounting, etc., all or at least the major portion of the costs should normally be indirect. In those cases where NASA contract costs are charged direct for activities which are normally treated by the contractor as indirect costs, similar costs directly applicable to the contractor's other business should be excluded from indirect expense pools allocated to all work.

g. A comprehensive plan by the contractor to control work performance is essential for effective financial management of R&D contracts. The plan should establish under each task and project, to the extent appropriate, a method for work surveillance. The method usually provides for the establishment of milestones which represent definitized progressive targets or stages to be reached during the progress of the work. For each milestone, records should be maintained to determine the effectiveness of performance by considering variances between the target and actual dates and variances between estimated costs and actual costs. The following guidelines should be used to evaluate the contractor's efforts to manage work performance:

(1) For selected contracts, evaluate the adequacy of contractor management reviews of the progress of work performance. Audit evaluation should include an examination of reports and/or minutes prepared to cover the reviews. Ascertain the extent that the reviews considered the correlation of the physical or technical progress of the work with the costs incurred.

(2) Where the deliveries of items or completion of the tasks under the contract were past due, determine whether contract costs increased as a result of the stretch-out of work.

(3) Ascertain whether time delays in completing phases of work were attributable to weaknesses in planning. For example, insufficient lead time may have been planned for the construction or acquisition of the necessary facilities to perform scheduled tests.

(4) Evaluate the number and significance of engineering changes, considering such factors as the number of change orders issued and the justification given for the changes. Determine whether fixed fees were increased or decreased commensurately with the change in the scope of work. If the fee was unchanged, determine whether a decrease was warranted.

(5) Examine the contents of technical reports issued under the contract to relate comments on technical progress to periodic financial reports. Is there evidence of technical difficulties which are not adequately reflected in estimated costs to complete the contract?

(6) Make arrangements to attend periodic NASA-contract or meetings on work progress. Relate problem areas discussed at these meetings with contents of periodic contractor reportings on costs and on status of funds.

(7) Ascertain and evaluate the extent that contractor representatives maintain surveillance over subcontractor operations. Do subcontractors furnish prime contractors with periodic reports on technical and financial progress? Are such reports prepared in a manner compatible with the data required in the NASA Form 533?

(8) Ascertain whether contractor representatives are required to prepare trip reports covering each visit to subcontractors. Evaluate the reports from the standpoint of business management functions. For example, where the need for additional funds to complete the work was reported, was appropriate action recommended and taken? Particular attention should be given to whether the reports covered the status of physical or technical progress in relation to costs incurred.

3-S204 Purchasing and Subcontract Practices at NASA Contractors

a. Make-or-Buy Decisions

Audit inquiry should be made into the contractor's policies and procedures in arriving at make-or-buy decisions. Audit inquiry should cover the composition of the committee or group responsible for such decision-making, the guidelines or factors to be considered in the decision process, and the nature of the documentation maintained in support of the decisions. Evaluate selected make-or-buy decisions.

b. Subcontractor Selection and Subcontract Administration

Many of the concepts relating to procurement activities by NASA in-house procurement elements have similar applicability to subcontracting and other purchasing actions by the prime contractor and higher tier subcontractors. The following are some of the significant points to be covered:

(1) The methods used by the contractor for selection of subcontractors and principal suppliers should be reviewed to assure that appropriate consideration is given to adequacy of subcontractor facilities, financial capabilities, and technical know-how.

(2) The type of subcontractual instruments used by the prime contractor should be evaluated as to their appropriateness in the individual circumstances (cost-type, incentive, time and materials, etc.)

(3) The audit should establish that the prime contractor conforms with the requirements of the contract by obtaining necessary contracting officer approvals of subcontracts.

(4) The sufficiency of cost and price analysis by contractor personnel should be examined in the light of the extent of competition obtained. It should be ascertained whether subcontractors were required to furnish adequate details of cost and profit make-up to permit evaluation and comparison of prices quoted. The nature and extent of further negotiations with the supplier awarded the subcontract should be reviewed. Special attention should be given to those cases where the successful bidder was other than the low bidder to ascertain that sufficient justification existed for the award.

(5) Selected subcontracts should be reviewed for possible ambiguities, absence of or revisions to standard clauses, contradictions of requirements, etc. For example, are delivery schedules in the subcontracts compatible with work requirements in the prime contract?

(6) Are engineering change orders promptly transmitted to subcontractors and are price changes due to such change orders negotiated promptly and at reasonable prices?

(7) Relative to (6) above, are delivery delays promptly pursued?

(8) Are required technical, administrative, and financial reports submitted by the subcontractors to the prime contractor? Are such reports being used for subcontract management purposes?

(9) Have necessary arrangements been made for contract administration, audit, etc., at the subcontractors for the interchange of pertinent information?

3-S205 Inventory Management

Effective inventory control is essential to assure a proper balance between inventory supply and production requirements. Among the matters to be included in the review of this activity are:

a. Indications of overbuying, tying up funds in excess inventories which are not contributing directly to the current program.

b. In establishing inventory requirements, is consideration given to the problems of frequent change orders obsoleting certain items?

c. Does the contractor have a program for standardization of component parts as a means of reducing the need for separate buying for individual contracts?

d. Items of material identified as excess, obsolete, or otherwise in long supply should be examined as to the cause of these conditions. Conversely, items in short supply should be similarly reviewed for causes.

e. Are effective procedures used to evaluate the economic reparability of production rejects?

f. The contractor's procedures for disposal of scrap should be evaluated. For example, are classification procedures adequate to determine what is usable, salvage, or scrap; are competitive bids secured for sale of scrap?

3-S206 Engineering and Scientific Manpower Utilization

a. It is important to emphasize in this area that it is neither contemplated nor intended that the auditor evaluates technical performance as such. However, the auditor can, for example, be of substantial benefit in helping to ascertain whether the financial controls are adequate to assure that NASA is obtaining commensurate value, in terms of level of effort and output, from the cost input in this area.

b. In light of the above, review in this area should cover:

(1) The system of internal management controls established by the contractor to accumulate and report data with respect to time expended by engineering and scientific personnel and the progress made.

(2) The reliability and completeness of the recorded data and the reports submitted to contractor and NASA management.

(3) The action taken by the contractor's management to control direct engineering and scientific effort.

(4) Coordination between technical and administrative personnel.

3-S207 Facilities and Equipment

Audit inquiry in this area should include such matters as:

a. The relationship between the investment of the contractor and of the Government in facilities for contract performance. This relationship is significant in evaluating the reasonableness of fees in relation to estimated contract costs, since a relatively high Government investment should ordinarily be reflected in a lower rate of fee than would be the case where the contractor utilized its own facilities.

b. Procedures used by the contractor to secure new and unused production equipment. Do such procedures include provision for attempting to secure Government-owned equipment?

c. Are Government-owned facilities being used by contractors on commercial work for which a lease arrangement has not been effected?

d. Is there any idle Government equipment at the contractor's plant? If so, has it been reported to responsible NASA officials? If not reported promptly, delays could result in contractors at other locations procuring like equipment unnecessarily.

e. Is there evidence of unused or partially unused plant facilities? If so, what is the effect on the NASA contracts? For example, where only partial use is made of facilities, NASA may be inequitably sharing the fixed overhead applicable to the facilities. Review should also be made to ascertain whether the contractor is performing work on the same contract at more than one plant when adequate facilities and capacity are available at a single plant.

f. What controls are exercised to assure that previously acquired capital assets reimbursed by the Government are not considered in pricing subsequent procurement?

3-S208 Engineering Changes -- NASA

This area is particularly significant in the light of its impact on costs and potential overruns. Audit analysis should therefore be directed toward:

- a. Evaluation of the contractor's procedures for the implementation of engineering change orders. Do the procedures provide for measuring the cost of the change (upward or downward) against the nature of the technical modification?
- b. Review of the contractor's estimating procedures to determine their reliability as a basis for negotiation of changes to the contract price.
- c. Is effective coordination established with subcontractors affected by engineering changes? Are costs of making changes at subcontractor's plants appropriately considered?

3-S209 Indirect Costs - NASA

Depending on the sensitivity and dollar significance of the indirect cost elements, audit coverage should encompass, in addition to the verification aspects, assurance that the contractor's policies and procedures under which the costs were incurred are reasonable and whether management controls are effective in precluding the incurrence of excessive or unnecessary costs. Special attention should be given to such sensitive and controversial items as:

- a. Independent research and development and bid and proposal costs (see 7-1500).
- b. Bonuses
- c. Pension, and profit-sharing plans (see 7-1500).
- d. Overtime costs (see 6-400).
- e. Executives' compensation (see 5-803.1).
- f. Recruitment costs (see 6-400).
- g. Pre-contract costs (see 6-200).
- h. Royalties and other costs for use of patents (see 7-700).
- i. Travel and relocation expenses (see 7-1000).

3-S210 GAO Audits at NASA Contractors

Information concerning GAO audit activities is understandably of particular interest to NASA management. Accordingly, report coverage should include appropriate data and commentary on such matters as:

- a. Have the NASA contracts been audited by the GAO from their inception to date? If so, the approximate dates of each audit should be indicated.
- b. The major GAO comments (oral and written), areas of interest, etc.
- c. GAO reports issued. Include title, number, date, major findings, chief recommendations, contractor responses, AF and Navy responses, NASA responses, action taken by the company, agency, contracting officials, auditors, etc.